

**The New
Generation:
Growth
Opportunities
and Business
Strategies**

**PepsiCo, Inc.
1986**



TACO BELL.

Financial Summary

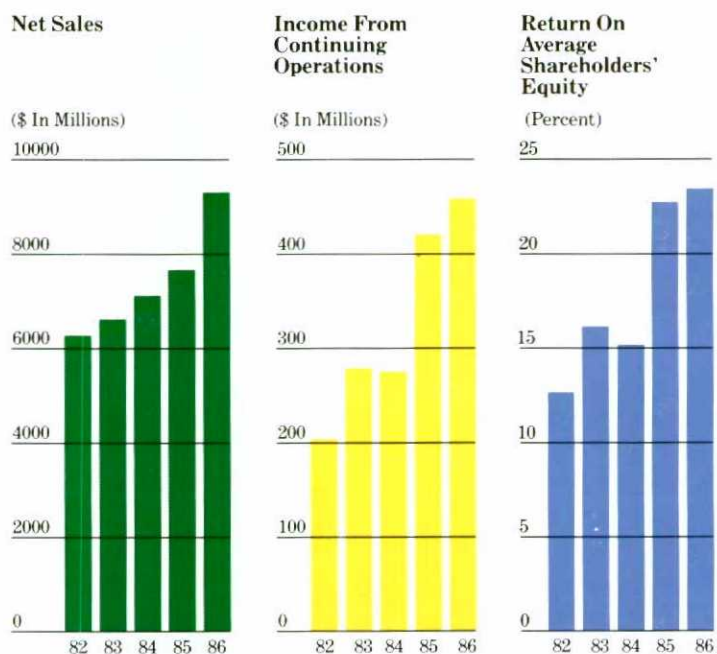
	1986	1985	Percent Change
Net sales	\$9,290.8	7,653.4	+ 21
Income from continuing operations	\$ 457.8	420.1	+ 9
Per Share	\$ 1.75	1.50	+ 17
Income from discontinued operations	\$ -	123.6	-
Per Share	\$ -	.44	-
Net income	\$ 457.8	543.7	- 16
Per Share	\$ 1.75	1.94	- 10
Cash dividends declared	\$ 162.6	161.2	+ 1
Per Share	\$.628	.585	+ 7
Property, plant and equipment expenditures	\$ 886.3	785.9	+ 13
Cash generated by continuing operations	\$1,231.3	819.9	+ 50
Return on average shareholders' equity	% 23.5	22.8	+ 3

(in millions except per share amounts)

Income from discontinued operations in 1985 primarily includes the net gain on the sales of North American Van Lines and Wilson Sporting Goods and the results of these operations through the dates of their respective sales. See Note to the Consolidated Financial Statements on page 42 for more information.

The per share information reflects the 1986 three-for-one stock split.

Return on average shareholders' equity was calculated using income from continuing operations.



PepsiCo, Inc.

PepsiCo has achieved a leadership position in three major domestic and international businesses. They are among the largest and fastest-growing consumer markets:

- Soft Drinks
- Snack Foods
- Restaurants

We've carefully selected these businesses because they provide continuing opportunities to stimulate increased sales and earnings—largely through our own actions.

Our long-term corporate objective is to maximize shareholder value, primarily through internal growth and astute application of our financial resources. Our 214,000 employees are dedicated to keeping PepsiCo one of the premier growth companies in the world.

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To Our Shareholders and Employees:

I'm pleased to report that we strengthened and expanded our business in 1986, while achieving record financial results. Here are some highlights of our continuing efforts to maximize shareholder value:

- Income from continuing operations rose 17 percent to \$1.75 per share.
- Sales increased 21 percent to \$9.3 billion.
- Cash flow totaling \$1.2 billion enabled us to cover record capital expenditures and dividends from internally generated funds.
- Shareholders' equity rose 12 percent to \$7.91 per share, and our return on average shareholders' equity reached an all-time high of 23.5 percent.
- A three-for-one stock split broadened the appeal of PepsiCo stock, substantially increasing our ownership base.
- Acquisitions within our existing businesses totaling \$1.7 billion enhanced our long-term performance prospects, without significantly diluting earnings.
- We smoothly completed a planned transition in senior management and established an even more decentralized organizational structure.

A Successful New Strategic Focus for 1986

Numbers alone, as good as they are, don't tell the full story of how well we really did last year. To gain that perspective, we have to go back to 1984. That's when, under Don Kendall's leadership, we undertook a very important strategic restructuring of our total operations:

- We decided to sell our foreign bottling operations to local business leaders who have the detailed knowledge of market conditions and the personal commitment necessary to maximize growth opportunities in this high-potential business.
- We withdrew from the transportation and sporting goods businesses, at a substantial net gain, because they did not fit strategically with our consumer products operations.
- We focused our resources on soft drinks, snack foods and restaurants—very profitable businesses with high rates of return. They are also very responsive to product innovations and creative promotions. We believed we could use our marketing and financial strengths to create additional growth opportunities.

As a result, we entered 1986 with a new vision and a new strategic focus. We were committed to increasing both the size of our markets and our share of them. And we were committed to providing for even higher returns on our investments in these rapidly growing businesses over the long term.

I'm very pleased with our performance against each of these objectives. I particularly want to call your attention to four key subjects:

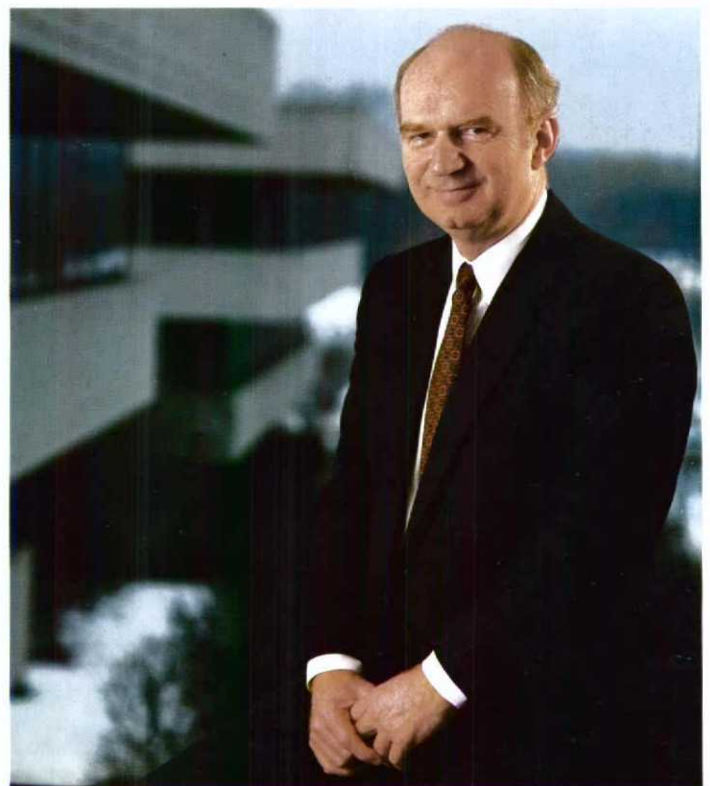
- the strategic importance of our acquisitions,
- the outstanding performance of our soft drink business,
- our continuing confidence in restaurants, and
- some actions we've taken to restore profit growth at Frito-Lay.

I'll also cover our ongoing commitment to growth and why I believe we're well-positioned to maximize our opportunities in the years ahead.

Acquisitions Increase Earnings Potential

Our existing businesses provide excellent opportunities for growth and increased profitability. We've improved both our current performance and our long-term potential through three major acquisitions that strategically complement these businesses:

- Kentucky Fried Chicken—the leader in the quick service chicken market and the second largest restaurant system in the world, acquired in October for \$841 million. It's performance and prospects are excellent. And KFC provides a critical mass that should accelerate our growth and profitability in this very attractive business.
- MEI Corporation—purchased in May for \$591 million, was Pepsi-Cola's third largest bottler and one of the most



D. Wayne Calloway
Chairman of the Board and Chief Executive Officer

successful and profitable in our system. A sound investment for both strategic and financial reasons, MEI significantly strengthens our domestic soft drink business.

- Seven-Up International—the third largest franchise soft drink operation outside the United States, purchased in July for \$246 million. It provides us a leading position in the lemon-lime segment, which accounts for 15 percent of the foreign soft drink market. More importantly, Seven-Up International provides the critical mass that increases our overall volume, strengthens our bottler organization and significantly enhances our competitive position outside the United States.

Major Gains in a Growing Soft Drink Market

Our improved results in 1986 were led by major gains in our soft drink business. Operating profits were up 23 percent on a 32 percent increase in dollar sales.

An important measure of the continued vitality of soft drinks is the gain in volume we achieved worldwide. In the United States, case sales of Pepsi-Cola brands were up seven percent—and grew 70 percent faster than the industry. And in foreign markets, Pepsi-Cola's volume gain of six percent was the highest increase in more than five years.

Our share of the U.S. retail market reached an all-time high of 31 percent. Brand Pepsi volume was up, and Diet Pepsi again was the fastest-growing diet cola in foodstores.

As pleased as we are with our performance in 1986, we believe there still is tremendous growth potential in the soft drink business. The best and most recent example of our ability to generate dramatic growth, even in very large markets, is the Slice family of juice-added soft drinks. We discuss this latest new product success in a special section beginning on page 7.

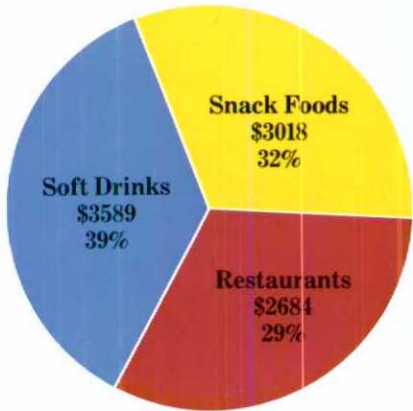
Restaurant Outlook Merits Continued Investment

We have great confidence in the growth and vitality of the restaurant business, and the quick service market in which we operate is particularly attractive. It's the fastest-growing restaurant segment, and is expected to continue outperforming the overall industry.

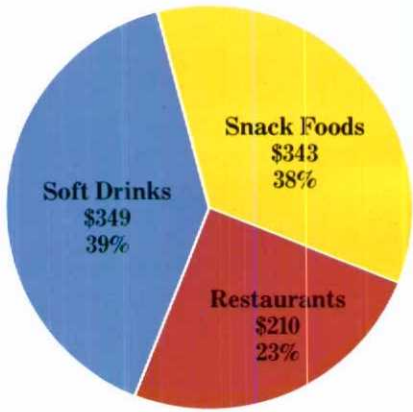
With KFC, we now have the leadership position in three of the four largest and fastest-growing categories of the quick service restaurant segment—pizza, chicken and Mexican food. And, with nearly 14,700 units, the PepsiCo system is now the largest restaurant organization in the world—nearly 50 percent larger than McDonald's.

We're well-positioned for significant long-term sales and earnings growth. In addition to our acquisition of KFC, we continued throughout 1986 to make major investments in new products and in additional restaurants. We believe these investments will ensure our ability to continue outperforming the

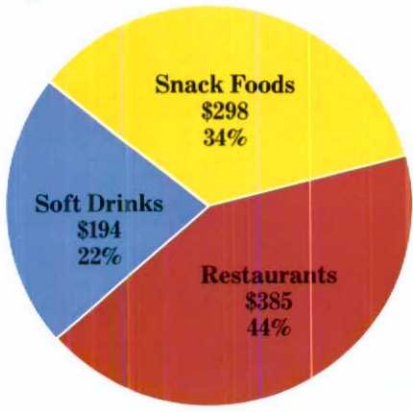
Net Sales
Total: \$9291
(In Millions)



Segment Operating Profits
Total: \$902
(In Millions)



Segment Capital Spending
Total: \$877
(In Millions)



restaurant industry and enhance our leadership position.

We're also moving aggressively into home delivery at Pizza Hut. It's a very exciting and high-potential market—in fact, the fastest-growing category in the entire restaurant industry. Start-up costs for delivery depressed our restaurant profits, which would have been up more than 10 percent from last year. Nevertheless, we're confident our investment in this emerging market will produce solid returns in the future.

Although the total restaurant industry was somewhat sluggish in 1986, it began to recover late in the year, led by the quick service segment. Our performance improved in the fourth quarter, and the momentum continues to build in 1987.

Restoring Profit Growth at Frito-Lay

Frito-Lay had a disappointing year—but I must put that statement in context because Frito-Lay routinely sets its sights much higher than most businesses. Frito-Lay was very profitable in 1986, our returns remained high, volume was up and dollar sales set a record for the 18th consecutive year. Nevertheless, operating income was down somewhat.

The primary reason was that consumer response to several new products did not meet our expectations. Many of the items were outside Frito-Lay's traditional salty snack category, and their attributes were not as easily understood as a new variety of potato or corn chips.

The relatively modest sales increase these new products generated simply could not offset the significantly higher promotional spending necessary to support them.

We're confident we've taken the corrective actions necessary to restore Frito-Lay's vitality and its customary pattern of annual earnings growth. We've withdrawn the underperforming products, eliminated incremental promotional expense and taken all necessary write-offs.

We'll continue to build our snack food business primarily through our very profitable major brands. That certainly doesn't mean we've abandoned new products, which have been the driving force behind the remarkable growth and profitability Frito-Lay has achieved over the past decade. But we plan to take advantage of our 1986 experience as we develop and more carefully test other new snack foods.

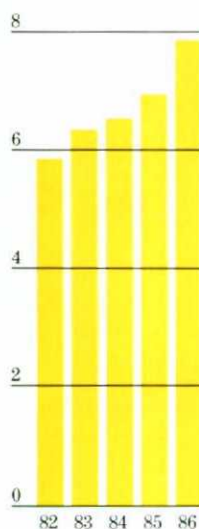
Don Kendall's Legacy of Leadership

After more than two decades as our chief executive officer, Don Kendall retired in May to become Chairman of the Executive Committee. There are many measures of this remarkable man, but consider just two:

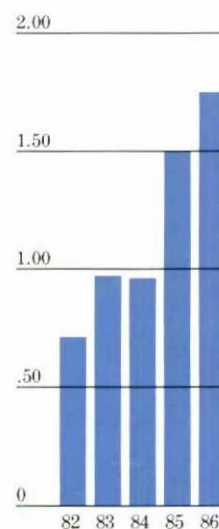
- The Board of Editors of Fortune magazine has just selected Don for induction into the National Business Hall of Fame, which recognizes "outstanding business leaders who have contributed significantly to the growth of the private enterprise system and of this country." Don joins such business legends as Andrew Carnegie, Thomas Edison, Alfred Sloan and John D. Rockefeller.
- From an entirely different perspective, the NAACP Legal Defense and Educational Fund awarded Don its first Equal Justice Award. The Fund recognized Don's leadership in public affairs and social responsibility, noting: "By demonstrating throughout his career a genuine openness of mind, a restless searching for fresh opportunity and a spaciousness of vision often all too rare in the higher reaches of corporate life, Don Kendall has provided for future generations a model of enlightened, progressive and authentic patriotism—blended with true citizenship of the world and a lifelong, unshakeable dedication to the cause of equal justice."

Don's rich legacy includes a management team of exceptionally talented men and women. Every one of the positions

Shareholders' Equity Per Share
(In Dollars)



Income Per Share From Continuing Operations
(In Dollars)



in the management transition Don planned was filled from within our company, evidence of our management depth. And our organizational structure remains lean and informal, based on open and honest communications among people of the highest integrity.

We put our best talent against our most important challenges. That's why in November Mike Jordan, who was our corporate president, took on new responsibilities as President and Chief Executive Officer of PepsiCo Worldwide Foods.

We realized the importance of returning our snack foods business to double-digit levels of growth and profitability, and Mike clearly was the best choice for this critical position. He already has made important progress against that key objective.

We also further decentralized our operations by creating PepsiCo Worldwide Beverages, under the leadership of Roger Enrico, President and CEO of Pepsi-Cola Company. Roger was elected to our Board of Directors in February 1987.

A Continuing Commitment to Growth

Annual Reports, by their nature, are historical documents, highlighting past results. We've taken a somewhat different approach this year that we hope will be more useful.

In covering each of our major businesses, we've tried to put our actions in perspective by describing the markets in which we operate and our leadership positions in them. More importantly, we also outline the strategies for growth behind both our performance in 1986 and our prospects for the future—when the “New Generation” grows up.

Since 1980 we've introduced new products that in 1986 accounted for U.S. retail sales totaling nearly \$5 billion. This clearly demonstrates the success of our business strategies and our commitment to volume growth. Our past achievements give us confidence in our ability to achieve consistently high levels of profitable growth in the next five years, as well.

In a fast-paced and highly competitive business environment, we obviously can't reveal precisely what actions we'll take in the future. What we do hope to communicate is that we have the quality products, resourceful management, financial

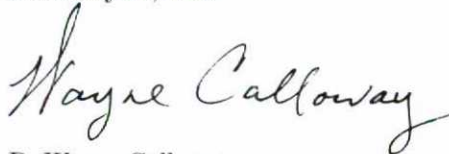
strength and sound business strategies that will enable us to achieve impressive results in highly competitive markets.

Solid Operating Gains Ahead in Each Segment

The outlook for PepsiCo is very bright. Our management team is committed to achieving the highest possible returns in each of our operations. We'll continue to increase shareholder value by striking an effective balance between long-term profit growth and annual improvements in financial results.

1986 was a very good year. We expect 1987 to be even better. We believe we can again achieve double-digit growth in earnings per share. And, more importantly, we believe we can achieve strong growth in operating profits in each of our businesses. By maximizing the value of your investment in PepsiCo, we hope to maintain your continuing support as a shareholder.

February 26, 1987



D. Wayne Calloway
Chairman of the Board and Chief Executive Officer

Slice: A Case Study



Growth Through New Products, PepsiCo Style

A successful new product—that's frequently one of the best and fastest ways for a consumer products company to grow.

Of course, not every new product will be a success. It not only has to meet consumer demands, but satisfy bottom-line profit requirements as well.

At PepsiCo, our new product batting average is not perfect. But we succeed more often than most companies. And our successes tend to be major ones, by virtually any standard of measurement.

To provide some insight into our approach to growing the business through new products, we've focused on the best recent example of just how successful a new product can be: Slice.

Slice Growth Through New Products, PepsiCo Style

More than 2,000 new food and beverage products are introduced every year.

Some 95 percent of them fail.

Retail sales of "successful" new

The point of difference: 10 percent fruit juice.



The original concept behind Slice was a better-tasting lemon-lime soft drink. But what appealed most to consumers was the addition of fruit juice.

grocery products average well under \$100 million a year.

And then there's Slice:

- the first soft drink with 10 percent fruit juice.
- one of Fortune magazine's 10 best new products of 1986 and the industry's "hottest" entry.
- a brand that didn't even exist until June 1984, but whose enormous popularity produced retail sales of almost \$1 billion in 1986.
- a beverage that reached a new category of consumers and expanded the entire soft drink market.
- already one of the top five soft drink trademarks, it covers a growing product line including the number one orange flavor in the United States.

In some ways Slice is unique. Few

new products reach retail sales of a billion dollars in only their second year.

But Slice also typifies the success of PepsiCo's continuing emphasis on product innovation. And it clearly demonstrates one of PepsiCo's major strengths: the ability to stimulate growth through our own actions.

Here's how we did it with Slice:

Find a point of difference

When we look for a new product, we look for a big idea.

In early 1982 PepsiCo was developing a lemon-lime soft drink for a segment of the market where we weren't well-represented.

But a good-tasting lemon-lime would only be another entry on an already crowded grocery store shelf.

The major challenge: create a competitive edge—a point of difference.

The creative insight: the major successes in the soft drink market over the past decade involved *taking something out* of the product—calories and caffeine. What if we *added something*—something that reflected quality, value, wholesomeness?

The answer: add fruit juice.

The technical problem: adding juice generally makes a soft drink appear cloudy, and U.S. consumers prefer their drinks clear and sparkling. Could we produce a juice-added soft drink, of consistently high quality, that was clear and sparkling?

Taking prudent business risks is an essential part of our corporate culture. And this was exactly the type of risk we believe in taking.

Don't take "No" for an answer

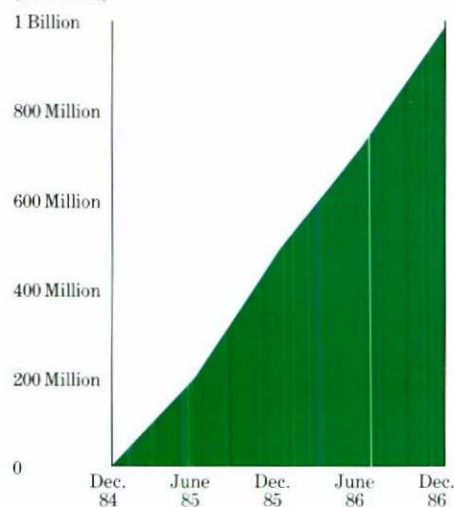
Pepsi-Cola's research and development team went into action—developing countless formulations and testing their taste, quality, clarity and shelf stability.

The result: a continual stream of failures, month after month.

The juice-based product soured,

Slice: Now a \$1 billion brand.

(In Dollars)



clouded, turned color and quickly deteriorated. At best, it was inconsistent. Conventional wisdom said it just couldn't be done—and lab tests seemed to prove it.

But as long as there was something else to try, "No" was not an acceptable answer.

Persistence paid off.

Finally, in the spring of 1983, one laboratory batch came out perfect. It was a clear, delicious, refreshing drink—and it maintained its quality.

There was just one small problem. We couldn't duplicate the sample under real-life production conditions.

It was back to the lab for several more months of intensive effort, followed by production tests in prototype bottling lines we set up in company-owned plants.

Finally, in the fall of 1983, it all came together: a lemon-lime soft drink with 10 percent juice—crystal clear—with a light, crisp, juicy taste—in both regular and diet versions.

The R&D team was convinced that the problems were behind them. They nicknamed the new drink "Overlord,"

after the code name for the Normandy invasion. Consumers would love it, and it would surprise and overwhelm the competition.

The celebration was premature.

Keep the focus on the consumer

The new beverage *was* delicious. But in early taste tests, consumers just were not enthusiastic about another lemon-lime soft drink, regardless of the great taste. And they didn't recognize the critical point of difference—fruit juice.

Something was wrong. So the market research team developed a new approach: give the panelists all the facts. Tell them about the fruit juice—the value added, the point of difference. After all, that's what the advertising would do.

That produced the winning combination: a great-tasting product and a knowledgeable consumer.

Test results suddenly showed that an overwhelming majority of the panelists preferred the new beverage.

It was then that the research team realized they had been focusing on the wrong product characteristic. Consumers were not necessarily interested in another lemon-lime product, but they were *very* interested in a soft drink with juice added.

That was the Pepsi-Cola team's first indication of what the new product really meant: not just another soft drink, but an entirely new *category* of soft drinks.

Rely on individual effort and creativity

Before the new drink could be test-marketed, it needed a brand name, a package and promotional support.

Creativity is not a job for committees—at least not at PepsiCo. Individual effort is what really counts. That's why the staff at this critical stage totaled only two people: the vice president of new product development and the product's brand manager.

Working at a feverish pace with

High-impact advertising emphasized juice and refreshment.



Slice promotions identified the point of difference and effectively communicated it to consumers. The results: Slice was named one of the best new products of any type in 1986 and the soft drink industry's "hottest" new entry.

More than a new product— a new category.



A brand that didn't even exist until 1984, Slice is now an entire line of soft drinks, including the number one orange flavor in the United States.

package designers, marketing experts and personnel from the J. Walter Thompson advertising agency, this two-person team created the name "Slice," the easily recognized package and the theme "We Got the Juice"—a clear statement of the distinctive consumer advantage of Slice.

Television commercials took a fresh approach to soft drink advertising. They showed huge slices of fruit blasting through crystal clear liquid, providing high impact and instant recognition.

Commit our resources quickly but carefully

Our network of bottlers—franchised and company-owned—provides two major competitive advantages that most consumer products companies don't enjoy.

First—each bottling operation is relatively small and confined to a specific geographic area. So we can test products on a small scale. If the initial results

Nationwide promotional support.



Slice has been in national distribution less than two years, but the trademark is already familiar to millions of consumers—and football fans, thanks to the Slice airship at Super Bowl XXI.

don't meet our expectations, we can cut our losses quickly. We can change the product or packaging or promotions, and try again in another area. Or drop the idea entirely.

Second—taken as a whole, our nationwide network of bottlers is huge. So if a new product is a big success in initial tests, we can quickly expand to other markets and even have a new product on supermarket shelves coast-to-coast in a matter of weeks.

That was the case with Slice. It was introduced in Tulsa, Okla. —in both regular and diet versions. Customers loved it and quickly came back for more.

Results were the same in every test market. Lemon-lime became the fastest-growing flavor category. And Slice was responsible for virtually all that growth.

By the end of 1985, Slice was available in 80 percent of the country, and clearly on a roll.

Build success on success

At PepsiCo, a top-selling product is not the happy ending of a success story. It's only the beginning.

The addition of fruit juice was the point of difference that counted most with consumers. The lemon-lime flavor was only the first chapter, and in late 1985 Pepsi-Cola's R&D team started work on new Slice flavors. Slice was soon to become an entire line of juice-added drinks.

The first line extension was Mandarin Orange Slice. It's now the leading orange soft drink, even though it's currently available in only 60 percent of the United States. Quickly following were Cherry Cola Slice and Apple Slice, all in regular and diet versions.

By year-end 1986, retail sales of Slice had reached the one billion dollar mark. It was the number five trademark in the 100-year-old soft drink industry.

Its popularity had spawned a group of imitators, and Slice is now the leader in the new juice-added soft drink category—a category it created.

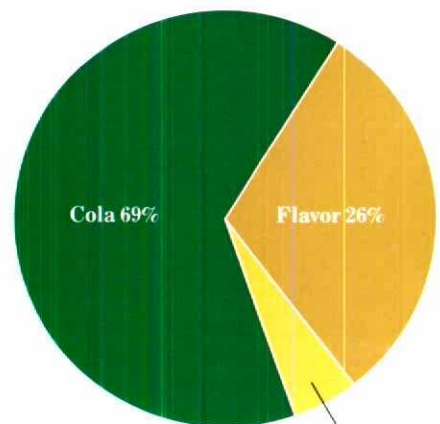
We had once again demonstrated the ability to stimulate our own growth—to create and then exploit big opportunities in big markets.

The Slice story: New products that broaden our business base and extend our reach to new consumers. It's also the story of Personal Pan Pizza and Priazzo Italian pie from Pizza Hut, Taco Salad from Taco Bell, and O'Gradys brand potato chips from Frito-Lay.

In fact, the new products we've introduced in the United States since 1980 accounted for retail sales in 1986 of nearly \$5 billion.

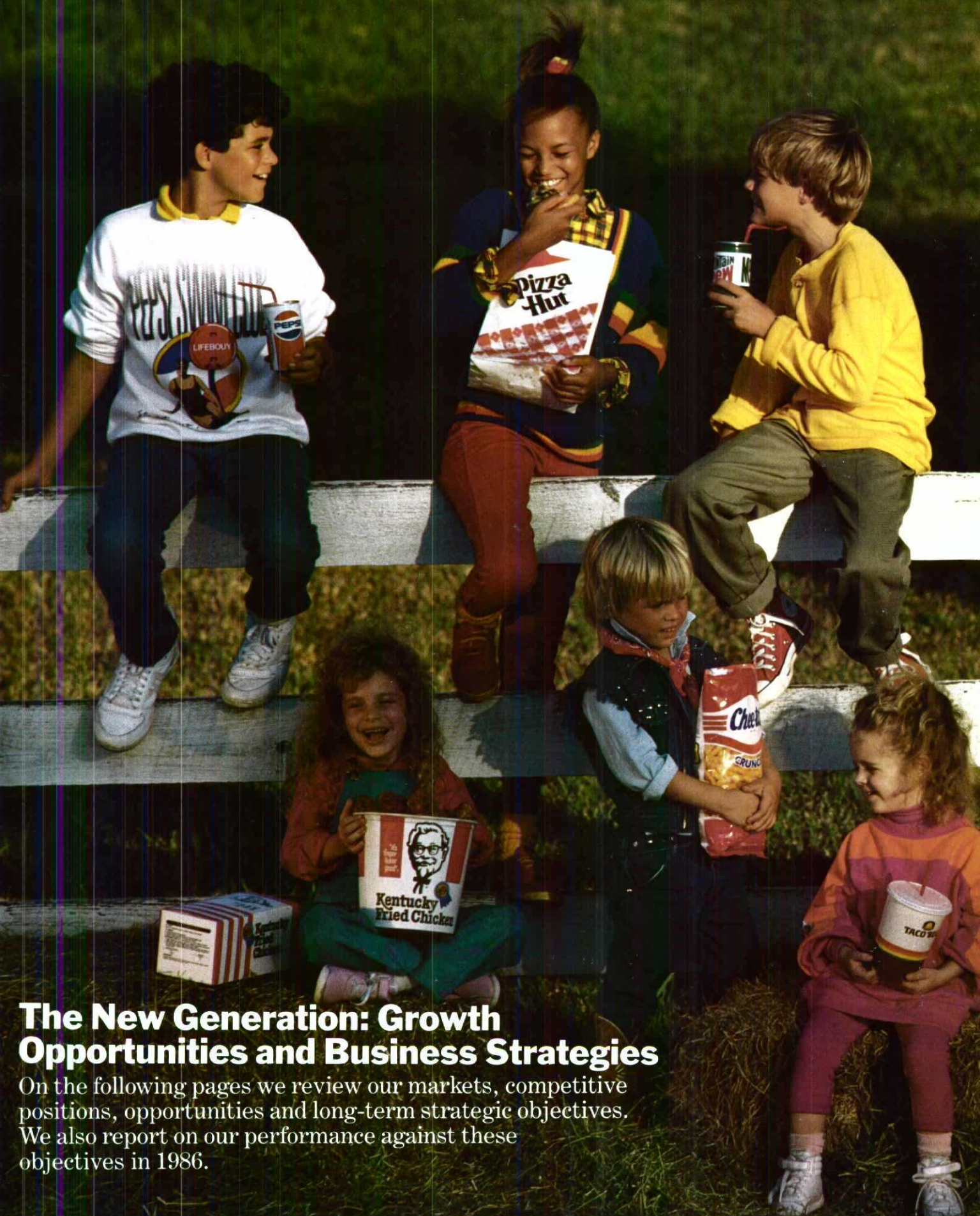
The qualities that produced our dramatic growth in the past are still very much a way of life at PepsiCo today. And they give us the confidence that we'll be able to create our own opportunities and drive our own growth for years to come.

Juice-added: 5% of all soft drinks.



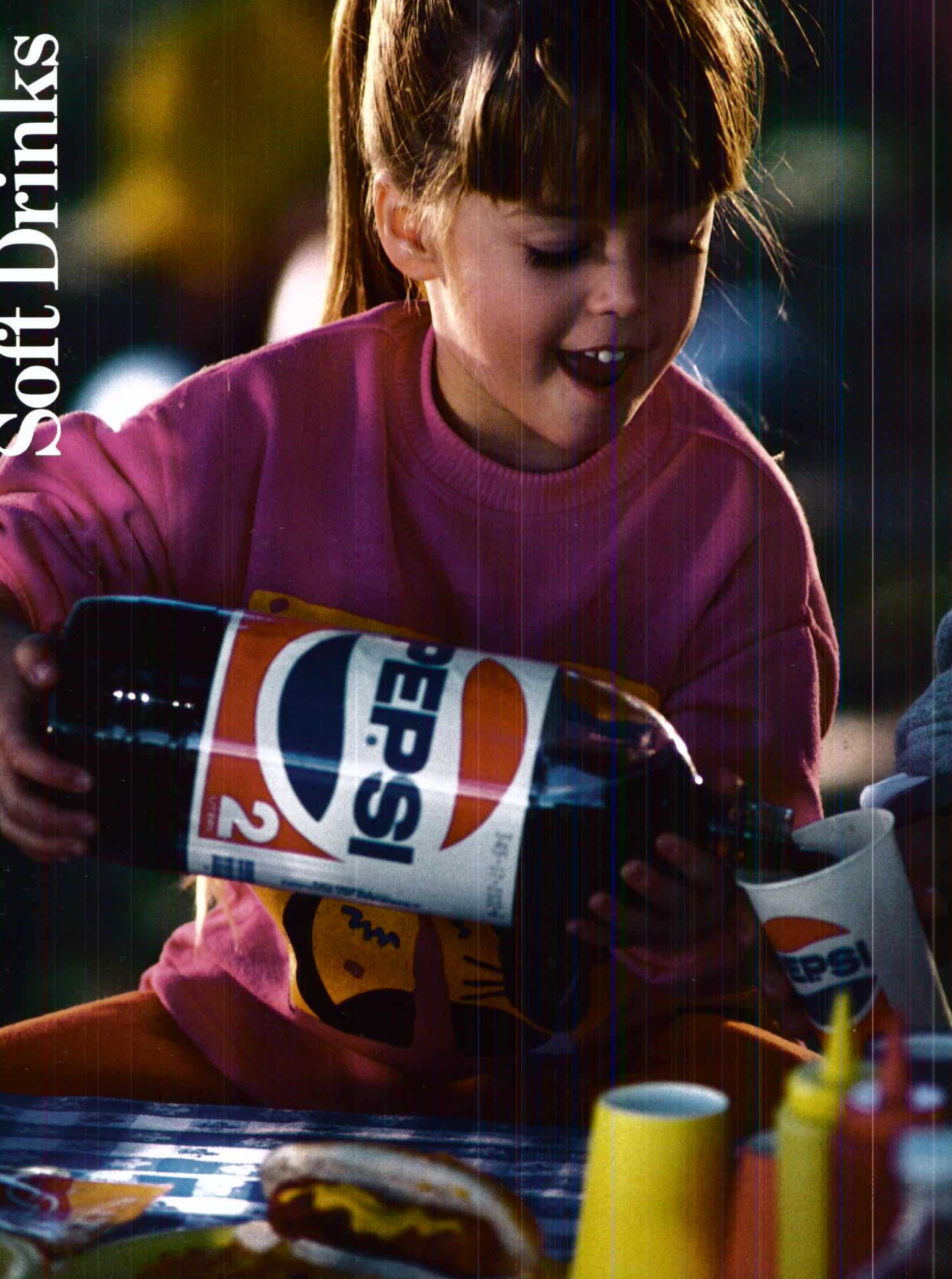
Pepsi-Cola's major presence in the cola market is complemented by the leadership of Slice in the juice-added market.

Operating Review



The New Generation: Growth Opportunities and Business Strategies

On the following pages we review our markets, competitive positions, opportunities and long-term strategic objectives. We also report on our performance against these objectives in 1986.



Soft Drinks

Market Perspective

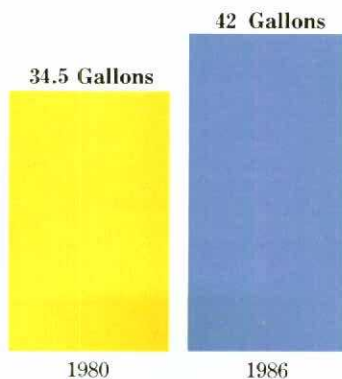
Americans consume more soft drinks than water—about 42 gallons a year for every man, woman and child. More soft drinks than milk, wine, juice, tea and liquor—combined. This adds up to an enormous soft drink market in the United States—seven billion cases which account for \$39 billion in retail sales. And per capita consumption over the last five years has been growing at an average annual rate of about four percent.

Despite this record level of consumption—and decades of continuing increases—industry growth shows no signs of leveling off.

That's because the soft drink consumption patterns acquired during youth are being maintained as the U.S. population ages. And diet and juice-added soft drinks are appealing to an even wider range of adult consumers.

The international soft drink market, estimated at 11 billion cases, offers even more potential. While the U.S. market includes some 240 million peo-

U.S. soft drink consumption: up 22 percent since 1980.



Growing soft drink consumption shows no signs of leveling off.

ple, the world population is approaching five billion. And per capita consumption of soft drinks outside the United States averages only about four gallons a year.

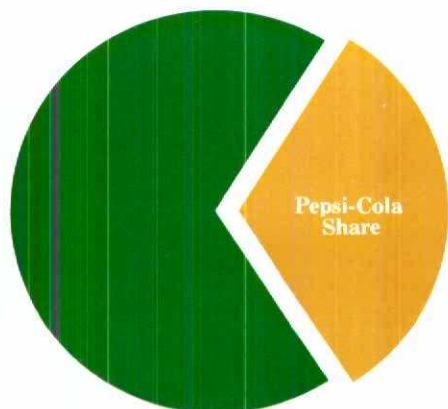
PepsiCo Position

PepsiCo's U.S. soft drink business—about \$12 billion in retail sales—accounts for approximately one-third of the total market. Over the last five years, Pepsi-Cola's volume has grown at an average annual rate of 6.5 percent—some 30 percent faster than the industry's five percent growth rate.

Pepsi-Cola's soft drinks are available primarily through franchised bottlers who manufacture, distribute, promote and price the products in their communities.

These franchised bottlers are complemented by Pepsi-Cola Bottling Group (PBG), a network of company-owned bottling operations located in major markets throughout the United States.

A one-third share of a large and growing U.S. soft drink market.



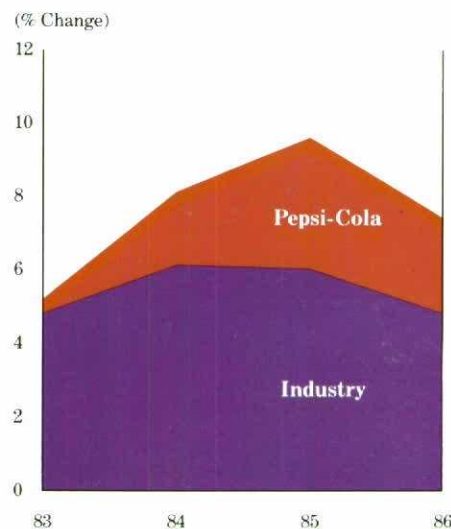
U.S. soft drink retail sales: \$39 billion.
Pepsi-Cola share: \$12 billion.

This system of franchised and company-owned bottling operations is based on a sharing of risk, responsibility and opportunity. It's a significant marketing and manufacturing advantage that enables the Pepsi-Cola organization to invest in new equipment and business systems—and to efficiently respond to consumer demand and introduce new products on a massive scale.

As a result of aggressive product and marketing actions during the past several years, Pepsi-Cola has now achieved a major presence in all channels of distribution.

In the early 1970s, Pepsi-Cola's primary objective was to market the best-selling soft drink in supermarkets, the largest distribution channel. We reached that goal in 1977, and brand Pepsi has remained the best-selling soft drink in supermarkets ever since. In fact, with retail sales of \$7 billion, Pepsi is the number one U.S. grocery brand of *any* type. And in convenience stores, another major distribution channel,

Pepsi-Cola vs. industry growth:



Pepsi-Cola's total case sales are growing some 30 percent faster than the industry.

Soft Drinks The New Generation: Growth Opportunities and Business Strategies

total Pepsi-Cola brands hold the leading position.

With supermarket sales generating strong volume and profits, we identified the food service channel, which accounts for one-fourth of all soft drink sales, as the next major opportunity for expansion.

The result? The Pepsi-Cola system now services an estimated 30 percent of the fountain syrup segment. In fact, our fountain share has grown 50 percent since a separate Pepsi USA Food Service Division was formed eight years ago.

Another key distribution channel, vending, accounts for about 13 percent of soft drink sales. In 1981 we launched

a major program to increase our share of this segment.

We've also increased our share of the overall soft drink market in other ways, including expanding our presence in both the cola and flavor segments.

Until 1964 we had only one strong brand—Pepsi-Cola. Then we added a diet cola—Diet Pepsi, America's first national diet soft drink—followed by Mountain Dew in the flavor segment. We expanded further in 1982 with caffeine-free colas and in 1984 with Slice.

We're also beginning to expand our presence in international markets, which generate 19 percent of all PepsiCo soft drink sales.

Our competitive position was dramatically strengthened with our 1986 acquisition of Seven-Up International. It significantly expanded our base of operations outside the United States, increasing our case volume by nearly 20 percent.

Strategies for Growth

Several fundamental strategies have accounted for our growth in the past and will guide our continuing expansion. These are:

1. Emphasize brand Pepsi.
 2. Build a strong portfolio of brands.
 3. Increase fountain syrup and vending sales.
 4. Leverage the operational excellence of our company-owned bottling system.
 5. Focus on high-potential but still underdeveloped international markets.
- Our strong position in a growing market enables us to pursue all these strategies simultaneously.

Performance

Soft drink performance continued to be outstanding in 1986, posting record levels in every important business category: share, volume, and profitability. In fact, over the last four years, Pepsi-Cola has been growing an average of nearly 50 percent faster than the industry rate. Strategies to maintain this momentum include:

1. Emphasize brand Pepsi

Soft drink preferences are often acquired at a young age. So Pepsi plays a special role in our overall marketing effort. It has broad-based appeal to all consumers, young and old. And as the flagship brand, generating more than half our soft drink sales, it sets an exciting tone for all our products.

In 1987 the centerpiece for our "New Generation" promotions is the

Pepsi-Cola: the best-selling brand of any product in supermarkets.



Soft drinks are the largest-selling grocery brand product. And brand Pepsi is the best-selling soft drink in this largest of all distribution channels.



Half of the top 10 restaurant systems serve Pepsi-Cola products.

Pepsi-Cola has about a 30 percent share of the fountain syrup market. Our soft drinks are available in five of the top 10 chains, led by Burger King, the second-largest restaurant system in terms of dollar sales.

reunion of Pepsi and superstar Michael Jackson, an agreement that will be supported by worldwide promotions, breakthrough advertising and music events.

2. Build a strong portfolio of brands

Total share of the retail market for all Pepsi-Cola brands hit an all-time high of nearly 31 percent.

Diet Pepsi is an excellent example of our ability to increase market share by building a strong portfolio of brands. In fact, last year was the best year ever for Diet Pepsi, and today it's the fourth largest-selling soft drink in the nation.

The success of Diet Pepsi in the intensely competitive diet cola market is reflected in 1986 sales that were up 18 percent from the prior year, and a total

of 52 percent from 1984. In foodstores the rate of increase of Diet Pepsi made it the fastest-growing diet cola for the second straight year.

Diet soft drinks now represent almost 25 percent of the market, and that share continues to grow, stimulated by their increasing popularity among males. We're responding to these additional opportunities with new Diet Pepsi advertising and bold new graphics that appeal to a broader range of consumers.

Mountain Dew, long a favorite of young consumers, also achieved significant growth in 1986, up more than six percent from the prior year.

At the same time as we were increasing the sales of our existing brands, we capitalized on the success of an entirely new brand—Slice. In 1986 Slice accounted for more than 60 percent of our total U.S. case volume growth. (See the section on Slice, page 7.)

3. Increase fountain syrup and vending sales

Our emphasis on these two important distribution channels has already achieved impressive results.

In fountain syrup it took Pepsi-Cola 80 years to reach the 50 million gallon sales level. But the next 50 million gallons took only eight years. Since 1979 the division has increased its share by an average of nearly 1.5 points per year.

A key to this growth—and to the promise of even greater gains in the future—is the unique and local service Pepsi-Cola offers our fountain system accounts through Pepsi-Cola bottlers.

Among restaurant chains, which represent more than two-thirds of the total, we now have more than 25 percent of the market. And our soft drinks are available in half the top 10 quick service restaurant systems.

In local food service accounts, which represent about a third of total fountain syrup volume, 1986 sales grew

even faster—in fact, at several times the industry rate.

In the vending market, we're also beginning to make significant inroads. Thanks to a systemwide focus on this highly profitable channel, our vending volume has increased by almost 25 percent in the last three years.

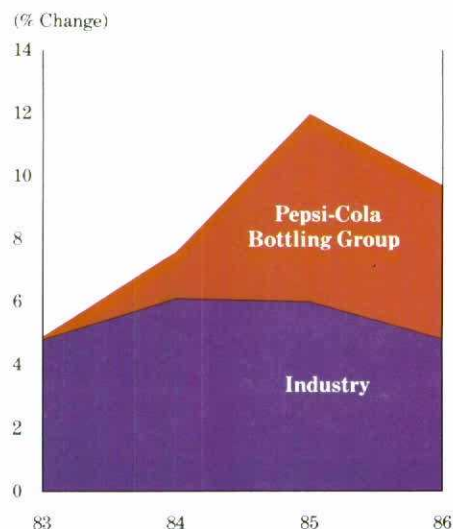
As our success in the fountain and vending channels provides still additional resources, we'll accelerate our development of these markets.

4. Leverage our operational excellence

In 1986 PBG, our company-owned bottling operations, achieved the highest profit growth of any of our divisions—up 66 percent including the results of our acquisitions.

PBG accounts for nearly one-third of Pepsi-Cola's U.S. volume, up from 23 percent in 1985. The network now includes 48 plants, 151 distribution systems and more than 4,000 sales routes.

Volume growth: PBG vs. industry.



Pepsi-Cola Bottling Group has been adding production capacity and market share for the past several years.

During 1986 our growth prospects and operating efficiencies were significantly enhanced with the purchase of MEI Corporation, Pepsi-Cola's third largest bottler. This addition, plus the purchase of several smaller bottling operations in 1986 and the acquisition of Allegheny Pepsi-Cola Bottling Company in 1985, increased PBG's total production capacity by some 100 million cases.

PBG operating profits are already benefiting from economies of scale. These include national purchasing contracts and aggressive investment in cost reduction programs, such as warehouse consolidation and bulk delivery.

PBG volume growth has considerably outpaced the industry for the last several years. And with its expanded base, PBG is even better positioned to take advantage of competitive opportunities.

5. Focus on high-potential, but underdeveloped international markets

Pepsi-Cola has built an increasingly important position in the international cola market. And now, with the July 1986 acquisition of Seven-Up International, we have a leading position in the

lemon-lime segment, which accounts for 15 percent of the international soft drink market. As a result of this broadened business base, Pepsi-Cola International (PCI) achieved record volume levels—up six percent in 1986.

Our soft drinks are now available in nearly 150 countries and territories, and we hold a leadership position in 45, including such major markets as Venezuela, the Soviet Union, China and Egypt.

In addition to increased sales, the acquisition of Seven-Up International provides the critical mass necessary to achieve major inroads in world markets.

Outside the United States, brand 7UP is sold in 85 countries, and in 55 of these it's the leading lemon-lime soft drink manufactured by a multinational producer. The acquisition also provides the opportunity for expansion into countries where PCI sells Pepsi-Cola brands, but where 7UP is not yet available.

Several high-potential international markets have been identified for further development over the next five years, including the Soviet Union. By the end of 1986, the Soviets opened their 16th Pepsi-Cola plant, increasing capacity to some 35 million cases a year.

7UP opens the international lemon-lime market to PepsiCo.



Overnight, the purchase of Seven-Up International put Pepsi-Cola International within range of becoming the international lemon-lime market leader. The purchase gives us exclusive rights to the 7UP brand in all markets outside the United States.

Seven-Up International is the third largest soft drink company outside the United States. It was purchased from Philip Morris Companies Inc., in July for \$246 million in cash.

High-potential foreign markets:

Per capita consumption of soft drinks is growing, but still low compared to U.S. averages.

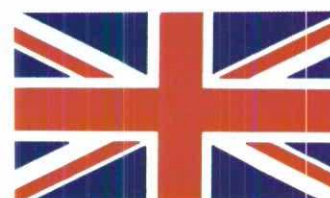
United States: 42 gal. per capita



China: .2 gal. per capita



Brazil: 10.5 gal. per capita



United Kingdom: 13.6 gal. per capita



Turkey: 1.7 gal. per capita



Netherlands: 15.2 gal. per capita

Another market with tremendous potential is the People's Republic of China, where Pepsi-Cola is already the largest multinational bottler. In China, the world's most populous nation with nearly 1.1 billion people, the total soft drink industry is only about 200 million cases, or about one quart per person. Pepsi-Cola now has two bottling plants in that country and is building a third, which will bring annual capacity to 15 million cases.

PCI also is strengthening its operations in more developed markets. PCI's newest joint venture is Britvic Corona, a partnership with Britvic Soft Drinks, Ltd., one of Great Britain's largest beverage companies. This partnership is expected to triple distribution of Pepsi-Cola products in Great Britain, and provide additional access to the pub and restaurant trade through an already well-established system.

These actions are expected to provide a basis for continuing growth.

Management's Analysis

(Note: the following discussion should be read in conjunction with "Business Segments" on page 32.)

1986 vs. 1985

Soft drinks sales increased 32 percent, and operating profits improved 23 percent over 1985. This growth reflected strong sales and profit gains from domestic operations and the positive impact of the acquisitions of MEI Corporation, Seven-Up International and Allegheny Pepsi-Cola Bottling Company. Excluding these acquisitions, 1986 sales and operating profits rose 12 percent over 1985.

The following discussion focuses on comparisons excluding the impact of these acquisitions.

The 1986 domestic sales improvement reflected continued strong volume

gains in company-owned bottling operations and in concentrate shipments to independent franchised bottlers. Domestic bottler case sales increased by seven percent in 1986, with strong gains in Diet Pepsi, new Slice flavors and fountain syrup sales.

Foreign sales growth was also strong, reflecting strengthening foreign currencies and increases in concentrate shipments to Canada and the Mediterranean region, partially offset by declines in Venezuela. Foreign bottler case sales rose six percent in 1986, led by Brazil, Argentina and the Mediterranean region.

Strong domestic profit growth in 1986 resulted from volume gains and improved operating margins in Pepsi-Cola's company-owned bottling operations.

Foreign results in 1986 reflected a \$19 million gain (including \$11 million of interest) from the collection of a receivable written off in 1978. Foreign results in 1985 included a \$26 million credit representing a favorable adjustment to the \$156 million charge in 1984 related to the planned sale of several company-owned bottling operations. Excluding these credits in both years, foreign results were even with 1985, as modest operating gains were offset by a write-off of goodwill.

1985 vs. 1984

Sales in 1985 advanced six percent as significant domestic gains were partially offset by lower foreign sales.

The 1985 domestic sales growth was due largely to a significant increase in shipments to independent franchised bottlers and volume gains by company-owned domestic bottling operations. Domestic bottler case sales rose 10 percent over 1984 as a result of the suc-

cessful introduction of Slice, growth of Diet Pepsi and the strong performance of brand Pepsi.

Foreign sales in 1985 were slightly lower than 1984 due to the sale of several company-owned bottling operations. Foreign bottler case sales improved two percent in 1985.

Segment operating profits more than tripled in 1985 as a result of the \$26 million credit in 1985 and the \$156 million charge in 1984 related to the planned sale of several foreign company-owned bottling operations. Excluding the 1985 credit and the 1984 charge, segment operating profits increased six percent in 1985.

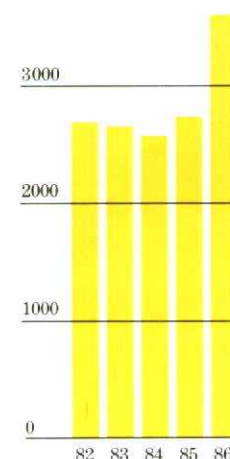
Domestic profits were even with 1984, as strong sales gains were offset by increased levels of competitive spending, primarily associated with the introduction of Slice.

Excluding the 1985 credit and the 1984 charge, foreign profits were up significantly over 1984. The 1984 foreign results were depressed due to substantial operating losses from the company-owned bottling operations.

Net Sales

(\$ In Millions)

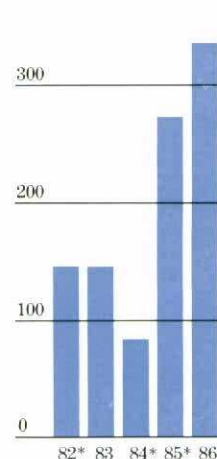
4000



Operating Profits

(\$ In Millions)

400



*Includes impact of unusual charges and credit related to foreign bottling operations. See pages 42 and 48.

Snack Foods



Market Perspective

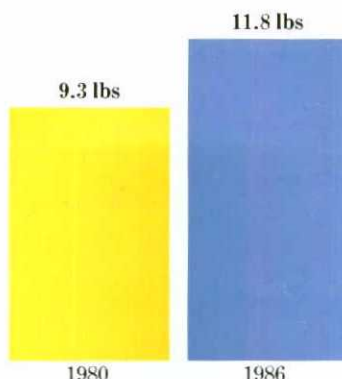
America is a nation of snackers. Retail sales of snack foods totaled \$24 billion in 1986. Salty snacks are one of the largest segments of the snack food market, accounting for more than \$6 billion in sales.

In the last five years, salty snack sales have increased at an average annual rate of nine percent. That's slightly less than in previous years, but still more than 50 percent faster than sales of the average grocery product. And in 1986, generally considered a sluggish year for the salty snack industry, sales were up almost six percent—and once again grew faster than grocery products in general.

The U.S. snack food market continues to be very attractive—for its sheer size, which can make even modest growth in dollar sales highly profitable, as well as for its responsiveness to new products and promotions.

The salty snack food market outside the United States is estimated at \$5 billion. Consumption in most inter-

A nation of snackers—eating more than ever before.



U.S. salty snack food consumption has grown some 25 percent between 1980 and 1986.

national markets is very small by U.S. standards and is just beginning to build, offering excellent growth opportunities for PepsiCo.

PepsiCo Position

With retail sales of more than \$3.5 billion, Frito-Lay is the leader in the domestic salty snack market.

Frito-Lay's growth has been excellent by any measure. In 1986 Frito-Lay achieved its 18th consecutive year of increased sales—with a growth rate nearly one and one-half times the average of all grocery store products.

Frito-Lay's exceptional growth is due in large measure to top quality products with well-known brand names that are extensively promoted through high-impact advertising.

Another key factor in Frito-Lay's success is its extensive manufacturing and distribution system—a network of nearly 1,800 facilities throughout the United States. Products are delivered directly to supermarkets as well as

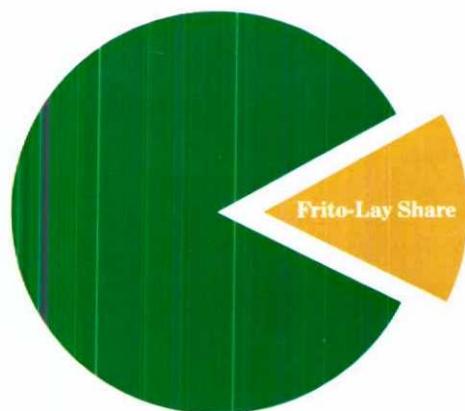
small retail outlets by a salesforce numbering more than 10,000 persons. This system permits us to promote and service our products at the point of sale.

This unique combination of competitive advantages enables Frito-Lay to achieve maximum results under a variety of market conditions and to consistently deliver fresh, quality products.

Outside the United States, PepsiCo Foods International (PFI) is a major multinational producer of snack foods. PepsiCo has company-owned operations, joint ventures or franchise operations in 11 markets. These operations involve 11,000 employees, 5,000 sales routes and 18 plants, and generate retail sales of more than \$600 million.

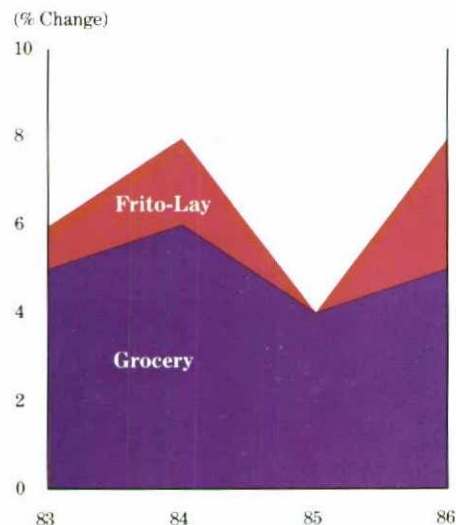
Yet PFI is represented in markets that account for only about one-third of the total international snack food sales. So the potential for growth is enormous. And PepsiCo is committed to stimulating that growth.

A large and growing snack food market.



**U.S. snack food retail sales: \$24 billion.
Frito-Lay share: \$3.5 billion.**

Frito-Lay brands vs. grocery product growth:



Sales of Frito-Lay brands grew more than 50 percent faster than the average of all grocery products in 1986.

Strategy: Increase sales of major brands through line extensions.



Nacho Cheese and Cool Ranch line extensions have increased retail sales of Doritos, Frito-Lay's largest-selling brand, to \$800 million.

Strategies For Growth

Our leadership position gives us confidence we can continue to grow our business and to expand the entire snack food market. We see opportunities in three key areas:

- continuing innovation in snack food products,
- operating efficiencies, and
- further development of international markets.

Here are five of the fundamental strategies we use to exploit these growth opportunities:

1. Continue to grow major core brands, utilizing line extensions wherever possible.
2. Keep the focus on the consumer through product superiority and brand differentiation.
3. Selectively introduce new prod-

ucts to reach new market segments and expand our customer base.

4. Reduce costs through increased productivity, utilizing new technologies and manufacturing efficiencies.

5. Introduce Frito-Lay's successful business systems and products to more of the world's markets.

Performance

Frito-Lay and PFI made important strategic gains in 1986 that provide the foundation for continuing growth.

1. Grow core brands

Seven big brands—each accounting for more than \$100 million in retail sales—produced nearly 80 percent of Frito-Lay's revenue in 1986. A primary objective is to enhance the growth of these core brands. How? Through line extensions. Familiar products—but in new forms, with new tastes.

During 1986 Frito-Lay introduced line extensions to three core brands.

The result: \$250 million in additional retail sales.

- Fritos brand corn chips achieved a sales increase of 12 percent versus the prior year—stimulated by sales of the new Chili Cheese variety. That's extraordinary growth for a 54-year-old product that already is one of the most successful in grocery stores.
- Lay's brand potato chips achieved significant sales growth through Lay's Jalapeño & Cheddar potato chips, which is capitalizing on the trend toward spicy Mexican food. The new flavor led to 15 percent sales growth for the entire brand—more than twice the growth rate of the potato chip category as a whole.
- Doritos brand tortilla chips, Frito-Lay's largest brand, grew 11 percent, to more than \$800 million in retail sales. The Cool Ranch line extension accounted for \$120 million of this total. An added benefit—Cool Ranch broadened the appeal of this number one product beyond the traditional teenage segment to the 20 to 34 age group.

These line extensions, plus intensified marketing of other products, increased sales of Frito-Lay's core brands by four percent.

2. Focus on the consumer

During 1986 Frito-Lay spent about \$250 million on high-impact advertising and promotion—to emphasize the point of difference for Frito-Lay products and to help consumers distinguish them from competitive brands. In the last five years, Frito-Lay has invested more than one billion dollars to promote its brands among a growing number of consumers.

Product superiority, widely recognized brand names and extensive promotional support— Frito-Lay keeps its focus on the consumer, and the consumer's focus on Frito-Lay brands.

Potato chip sales boosted by new flavors.



3. Introduce new products

One of Frito-Lay's most successful long-term strategies for growing the business is to introduce new products. This continuing emphasis on innovation has paid impressive dividends and produced new brands that become significant contributors to profits. A recent example is O'Gradys brand potato chips. Introduced in 1984, it's now a core brand, generating retail sales of more than \$100 million.

In 1986 Frito-Lay introduced a record number of new products to stimulate additional volume growth in a somewhat sluggish snack food market. Some of these new products were modestly successful, but Frito-Lay's performance objectives are high. As a result, several items were discontinued, and Frito-Lay focused its resources on those products that offered the highest growth potential.

Among the more successful new products Frito-Lay introduced in 1986 is Delta Gold brand potato chips. Sales of this new brand helped push Frito-Lay's total potato chips retail sales beyond \$1.3 billion—an increase of some eight percent in this major market segment.

Stimulated by new products and line extensions, Frito-Lay's 1986 potato chip sales reached a record \$1.3 billion.

Technological improvements help offset cost increases.



Technological innovations and productivity improvements have enabled Frito-Lay to save more than \$250 million in the last three years alone.

4. Reduce costs through technology and productivity improvements

We also increase profits by reducing costs. That's the goal of "Operation Offset"—a major cost reduction program introduced in 1983 with the objective of offsetting all manufacturing cost increases due to inflation.

"Operation Offset" has achieved remarkable success, exceeding its goals every year. For example, the total cost of manufacturing a pound of product rose only three-tenths of one percent in 1986. Over the past three years, Frito-Lay has reduced cost increases by \$250 million. These improvements

Sales of PepsiCo snack foods outside the United States:

14%

5. Introduce Frito-Lay's successful business systems and products to more of the world market

In major markets throughout the world, PFI is implementing systems similar to those being used so successfully by Frito-Lay in the United States.

In Mexico, for example, PFI has developed a store-door delivery system that includes more than 3,000 sales representatives calling each week on 300,000 outlets. The result? PFI is the leader in this huge market.

PFI also is successfully introducing several Frito-Lay products into international markets. Some examples:

- Line extensions of Ruffles and Doritos brands—and the introduction of O'Gradys brand potato chips—increased dollar sales in Canada by 13 percent.
- O'Gradys brand also helped increase potato chip volume growth in Australia by five percent.
- A new flavor of Fritos brand corn chips in Spain—backed by increased advertising—nearly doubled unit volume and increased our market share.

As a result of introducing line extensions and totally new Frito-Lay products into high-potential markets, PFI dollar sales, including joint ventures, increased 14 percent over the prior year. Yet, per capita consumption overseas is just beginning to build.

PepsiCo Foods International's successful introduction of Frito-Lay products and systems in international markets is leading to record systemwide sales, up 14 percent in 1986.

pay continuing dividends, and demonstrate that still greater efficiencies are attainable in the future.

Cost saving programs are in operation at every stage of production and distribution. For example, robot-guided vehicles transport finished goods, and computer-directed cranes load cases onto racks. This reduces labor costs and provides more efficient and less expensive storage.

Other technological innovations are being introduced in the sales organization. Hand-held computers will eliminate paperwork and give our sales representatives more time to do what they do best—sell.

High-potential foreign markets:

High-potential markets with low per capita consumption mean big opportunities for international snack food growth.

United States: 11.8 pounds per capita

Existing markets



Mexico: 1.1 pounds per capita



Spain: 1.1 pounds per capita



Canada: 6 pounds per capita

Developmental areas



Europe: .7 pounds to 6.2 pounds per capita



Far East: 3.6 pounds per capita

Management's Analysis

(Note: the following discussion should be read in conjunction with "Business Segments" on page 32.)

1986 vs. 1985

Net sales in the snack foods segment rose six percent, reflecting solid volume gains both domestically and internationally. Frito-Lay's total pound shipments, excluding discontinued products, advanced four percent, led primarily by core brand line extensions and new salty snack products.

PepsiCo Foods International's unit volume gained six percent, with modest growth in Mexico and strong gains in Brazil and Spain.

Operating results in 1986 and 1985 included charges related to strategic decisions to streamline Frito-Lay's product lines. In the fourth quarter of 1986, Frito-Lay recorded a \$52 million charge for the discontinuance of certain non-salty products and a reduction of cookie production capacity. Frito-Lay's 1985 operating results included a \$16 million charge related to the discontinuance of cookies in the large-sized package.

As a result, worldwide snack foods operating profits declined 13 percent in 1986 including these charges and three percent excluding the charges. Domestically, Frito-Lay's operating profits excluding these charges also declined slightly compared to 1985.

Frito-Lay's results reflected volume gains and moderate pricing which were more than offset by higher selling costs associated with major investment

spending programs to support new product and selling strategies.

Foreign operating profits also decreased from a strong 1985, primarily reflecting promotional spending in Canada and the adverse translation impact of the weakening Mexican peso.

1985 vs. 1984

Net sales advanced five percent, reflecting significant foreign growth and a modest increase at Frito-Lay. In 1985 Frito-Lay's total pound shipments, excluding discontinued products, fell four percent from 1984's strong performance, which featured the introduction of O'Gradys.

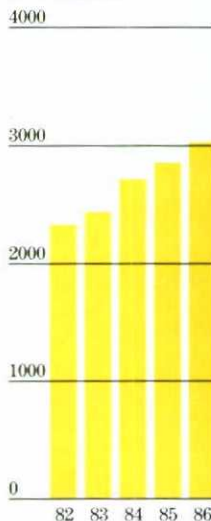
PepsiCo Foods International's 1985 unit volume increased 20 percent, primarily from significant gains in Mexico.

Segment operating profits were even with 1984. Excluding the 1985 packaged cookie charge, segment operating profits advanced four percent, with Frito-Lay's profits benefiting from favorable raw material costs and manufacturing efficiencies, partially offset by higher operating costs.

The 1985 foreign operating profits improved significantly over 1984, primarily due to higher profits in Mexico.

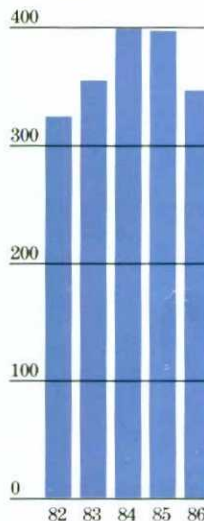
Net Sales

(\$ In Millions)



Operating Profits

(\$ In Millions)



Restaurants



Market Perspective

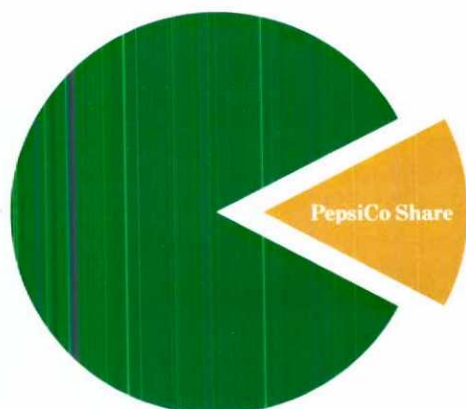
People are eating out more than ever. In the United States, total food service sales reached a record \$127 billion in 1986. It was the sixth consecutive year of industry growth, although the rate slowed somewhat.

However, quick service restaurants continue to outperform the industry and, in fact, are the fastest-growing segment. Sales total about \$50 billion—with the hamburger, chicken, Mexican and pizza categories accounting for more than three-fourths of the quick service segment.

Several major demographic trends create a favorable outlook for restaurants, one that is projected to continue over the long term:

- Single-person households now represent almost 24 percent of the U.S. population, up from 17 percent in 1970. And single people generally eat more meals away from home than do families.

PepsiCo system share of the U.S. quick service market segment:



U.S. quick service restaurant sales: \$50 billion.
PepsiCo systemwide share: \$6 billion.

Demographic trends create a favorable outlook for restaurants.

- More disposable income
- More single people
- More working women
- More two-wage earner households
- More food consumed away from home

- The trend toward more women working away from home is also benefiting the restaurant industry. As more women enter the work force, the need for convenience foods, carryout service and delivery becomes even greater.
- The increase in two-wage earner households means more families with more money to support their need for quicker, more convenient foods. The number of two-wage couples has increased from one-third of married households in 1970 to almost half now.

In addition, disposable income is increasing dramatically. It's projected to reach nearly \$4 trillion by 1990.

The international restaurant market is even larger, more attractive and faster growing than in the United States. And the demographics are similarly favorable—an increasing percentage of working women and a burgeoning working middle class with a larger disposable income.

PepsiCo Position

With the purchase of Kentucky Fried Chicken (KFC) in October 1986, PepsiCo now has the largest number of restaurants in the world. We're the leader in three of the four largest—and

fastest-growing—chain restaurant categories: pizza, chicken and Mexican food. The growth of these segments is expected to continue outperforming the industry.

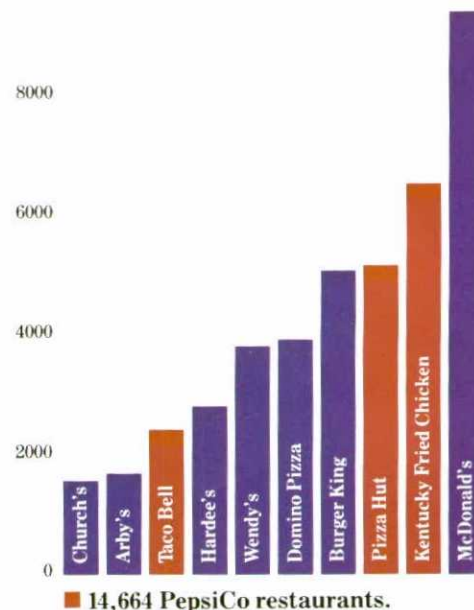
PepsiCo's systemwide sales in these rapidly growing segments now total more than \$7 billion worldwide:

- In the \$11 billion U.S. pizza category, Pizza Hut's 20 percent share is one quarter larger than its closest competitor.
- KFC commands 45 percent of the \$5.5 billion U.S. chicken category. Outside the United States, KFC is the only major quick service chicken restaurant system.
- And in the \$2.3 billion Mexican category, Taco Bell has over half of all

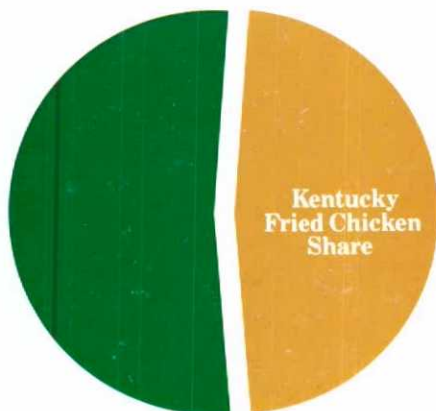
The largest restaurant chains in the world:

With the addition of KFC, PepsiCo owns three of the top 10 restaurant chains and is the largest system in the world.

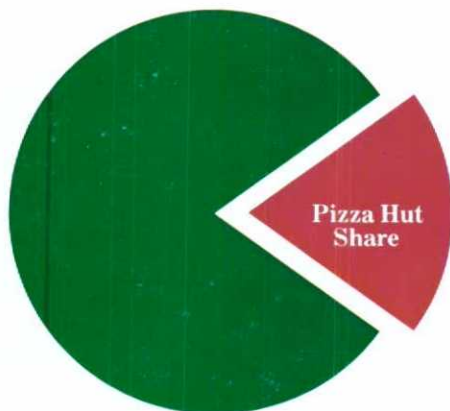
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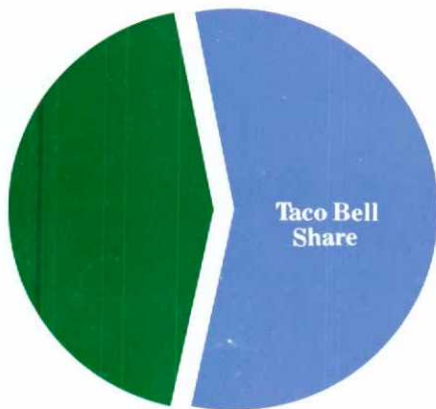
Restaurant market shares:



U.S. chicken restaurant market: \$5.5 billion.
Kentucky Fried Chicken share: \$2.5 billion.



U.S. pizza restaurant market: \$11 billion.
Pizza Hut share: \$2.2 billion.



U.S. Mexican restaurant market: \$2.3 billion.
Taco Bell share: \$1.3 billion.

quick service sales, making it more than five times larger than its nearest competitor.

In international markets the quick service restaurant industry is just beginning to develop—and PepsiCo is already well-positioned to take advantage of the growth potential overseas.

Strategies For Growth

We believe there are significant opportunities for substantial growth in the quick service restaurant industry. Because of our leadership position in three large and rapidly growing segments of this market, we can aggressively pursue several major strategies simultaneously:

1. Introduce new menu items, including product line extensions.
2. Expand distribution channels and customer base.
3. Further improve operational excellence.
4. Rapidly develop new units.
5. Strengthen our overall presence internationally by concentrating on high-potential markets, and expand operations through strong franchisees and joint venture partners.

Performance

Each of our restaurant systems applied these strategies in slightly different ways to achieve maximum results in 1986.

1. New menu items

Taco Bell—In the last three years, Taco Bell has introduced seven major new products, which have accounted for a significant portion of the system's exceptional growth. These products reach new consumer groups and are currently generating more than one-third of all dollar sales.

The momentum continued in 1986. Seafood Salad, served in a fluted tortilla shell, is a menu choice not found

in most other Mexican quick service restaurants. It attracts the increasing number of consumers interested in lighter foods and in fish dishes.

The Double Beef Burrito Supreme is an important new line extension and has increased burrito sales by nearly 50 percent.

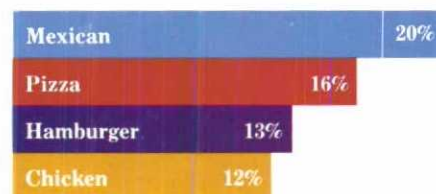
Pizza Hut—The latest new product success is Priazzo, a delicious Italian pie with a top and bottom crust stuffed with a variety of ingredients and topped with cheese. Introduced during the summer of 1985, the Priazzo line was expanded this year with two new versions. The result: Priazzo retail sales now total \$230 million.

KFC—The customer base is being expanded by nonfried foods and light, healthful meal and snack alternatives, as well as by an increased emphasis on lunchtime items.

Chicken Littles small chicken sandwiches, perfect for lunch and snacks, have achieved exceptionally strong results in test market. In fact, Chicken Littles are outscoring any other product KFC has ever tested.

Oven roasted chicken—a delicious chicken quarter, marinated and sprinkled with a special seasoning mix—is also doing well in test market.

Fastest-growing categories:



Compound annual growth rate, 1981-86.

PepsiCo is the leader in three of the four fastest-growing quick service restaurant categories.

2. Expand into new markets and new distribution channels

There are two primary examples of this strategy in 1986: The acquisition of Kentucky Fried Chicken and the entry of Pizza Hut into home delivery.

KFC—Already the leader in two very attractive restaurant markets, PepsiCo acquired KFC because it's the largest and best-known quick service chicken restaurant system in the world. Thanks to excellent management and a revitalization program begun in the late 1970s, KFC has consistently outperformed the restaurant industry over the past several years.

In 1986 net sales were up 19 percent over the prior year, and KFC again increased its share of the market.

There is still tremendous potential for growth. And KFC has strengthened its ability to exploit new opportunities

A wider menu choice attracts new consumers.



New Taco Bell products include Seafood Salad for consumers interested in lighter foods, and, for heartier appetites, Double Beef Burrito Supreme.

Restaurant sales growth:

PepsiCo franchise and company-owned restaurants have consistently achieved higher sales per unit than industry averages. Systemwide sales now total more than \$7 billion.

Average Domestic Unit Sales (\$ Thousands)—Combined Company and Franchise

	1981	1982	1983	1984	1985	1986	5 Yr. % Growth
KFC	375	388	431	459	502	529	7.1
PH	306	351	412	435	457	468	8.9
TB	385	390	436	539	550	560	7.8

Systemwide Sales (\$ Billions)*

	1981	1982	1983	1984	1985	1986	5 Yr. % Growth
KFC	2.3	2.4	2.6	2.9	3.1	3.5	8.8
PH	1.2	1.3	1.6	1.8	2.0	2.2	12.9
TB	.5	.6	.7	.9	1.1	1.3	21.1
PFSI	.08	.09	.11	.15	.24	.33	33.1
Total	4.08	4.39	5.01	5.75	6.44	7.33	12.4

*Totals include KFC, acquired October 1, 1986, as though it were part of PepsiCo.

PFSI division includes international Pizza Hut and Taco Bell operations.

with the June 1986 opening of a state-of-the-art research and development center, located next to KFC headquarters in Louisville, Ky.

Restaurant remodeling and upgrading continues to produce improved results. Because about three-fourths of KFC sales are take-out, drive-thru windows are being added wherever possible to further increase sales. And restaurant interiors have been redesigned to offer more seating and improved service.

The result? In the new and renovated units, eat-in business has increased by more than one-half and per store sales averages regularly exceed the system average.

Pizza Hut Delivery—

Delivery is the fastest-growing category in the restaurant business today. And Pizza Hut is already well-positioned in this emerging market

with a delivery system that features an important competitive advantage. In major markets customers call a single telephone number, which connects them with a computerized customer service center, linked to all Pizza Hut Delivery units within that area. The order is transmitted to the unit nearest the customer for immediate preparation and delivery.

Consumers' familiarity with Pizza Hut, its products and its reputation for quality have encouraged a high rate of trial. As a result, delivery is producing steady sales growth for the entire Pizza Hut system.

KFC is also expanding into the growing home delivery market, with tests in process in three major markets.

Pizza Hut's delivery system:



Delivery Countdown—an innovative approach to a high-potential market. The order is called in... confirmed... routed to the nearest delivery unit. The hot Pizza Hut pizza is placed in a special pouch for transport... and arrives at the customer's door within 30 minutes.

3. Improve operational excellence

Taco Bell—A new sophisticated scheduling system allows restaurant managers to predict with greater accuracy the number of customers in any 15-minute period. The resulting work schedule avoids overstaffing, yet improves overall service and quality.

Pizza Hut—An emphasis on employee development has helped reduce restaurant manager turnover by 50 percent over the past three years, leading to improved service and efficiency.

KFC—Computer-controlled frying is reducing waste and improving product quality and consistency. In addition, new equipment for frying, now in test, is expected to reduce shortening use and lower preparation costs.

4. Rapidly develop new units

Since 1980 PepsiCo has invested about \$1 billion in the Pizza Hut and Taco Bell systems to build some 1,300 company-owned restaurants and to upgrade existing units. Our franchisees have invested in an additional 1,500 units.

With the addition of KFC, which has been opening restaurants at the rate of about one per day, PepsiCo now owns or franchises the largest number of restaurants in the world—14,664. (See chart.)

5. Focus on high-potential international markets

PepsiCo has committed substantial resources to developing five major markets: Canada, Japan, the United Kingdom, Australia and Germany. These are countries where other major U.S. quick service restaurant systems also concentrate about three-quarters of their international development efforts. The size of these markets and the enthusiastic customer acceptance of U.S. restaurant concepts point to significant growth potential in the future.

Most of our international restaurants already are located in these

Restaurant growth 1981-86:

Over the past five years, PepsiCo's restaurant system (excluding KFC) has added units at a compound annual rate of more than eight percent. PepsiCo Food Service International (PFSI) units are growing at a compound rate of more than 20 percent.

Number of Units (Year-end 1981-1986)

Year	KFC	Pizza Hut	Taco Bell	PFSI	Total
1981	5,732	3,765	1,397	237	5,399*
1982	5,779	3,820	1,489	284	5,593*
1983	5,971	3,996	1,663	334	5,993*
1984	6,175	4,208	1,833	404	6,445*
1985	6,396	4,482	2,173	518	7,173*
1986	6,575	5,017	2,409	663	14,664
Five Year Compounded Annual Growth Rate					
	1.2%	5.9%	11.5%	22.8%	
Combined Pizza Hut, Taco Bell and PFSI					
Growth Rate: 8.4%					
*Totals 1981-85 do not include KFC.					

Number of Units (Year-end 1985)

	KFC	Pizza Hut	Taco Bell	Total
<u>United States</u>				
Company	1,246	2,533	1,309	5,088
Franchise	3,474	2,484	1,100	7,068
<u>International</u>				
Company	666	167	19	852
Franchise	1,189	462	15	1,666
Total	6,575	5,646	2,443	14,664

nations, and we're well-positioned to exploit additional growth opportunities. **KFC**—KFC has restaurants in some 54 countries, and will continue to concentrate its expansion efforts in the populous Pacific basin region.

More than half of KFC's international restaurants are located in this area, where chicken is a widely accepted food. In fact, some stores in that region achieve annual sales totaling nearly \$2 million.

Much of KFC's international growth will be generated through affiliation with strong local franchisees and joint venture partners, such as

Mitsubishi in Japan and Wattie Industries Limited in New Zealand.

Pizza Hut—With restaurants in 36 countries, Pizza Hut is the leader in the pizza segment worldwide. It has 10 times more restaurants outside the United States than the nearest competitor.

With our franchisees and joint venture partners, PepsiCo expects to build

more than 1,500 international Pizza Hut restaurants over the next several years.

Taco Bell—The Mexican restaurant segment is not yet as well-developed overseas, but Taco Bell is already establishing an international presence. There currently are Taco Bell restaurants in Canada, and in 1986 the first European Taco Bell opened in the United Kingdom.

High-potential international markets:

U.S. restaurant concepts have been enthusiastically received in these large and growing international markets, where PepsiCo will focus its development efforts.



Canada: 117 PepsiCo units



Australia: 425 PepsiCo units



United Kingdom: 447 PepsiCo units



Japan: 644 PepsiCo units



Germany: 21 PepsiCo units

KFC: Leadership in the fast-growing chicken market.



Kentucky Fried Chicken—the world's leading chicken chain restaurant and second largest total restaurant system—joined the PepsiCo family on October 1, 1986. It was acquired from RJR Nabisco, Inc. for \$841 million.

Kentucky Fried Chicken is one of the most widely recognized brand names in the world, as is the image of KFC founder Colonel Harland Sanders. To millions of consumers, KFC is chicken.

As one of the largest and most successful restaurant systems, KFC is an excellent strategic fit for PepsiCo. It's a logical extension of our existing business, both in the United States and in the more than 54 other countries where KFC operates. It's a partnership that will help KFC grow even stronger and increase its market share, while maximizing the growth potential of PepsiCo in the rapidly growing quick service restaurant market.

Management's Analysis

(Note: the following discussion should be read in conjunction with "Business Segments" on page 32.)

1986 vs. 1985

Net sales in the restaurants segment increased 29 percent, and operating profits improved six percent over 1985. These gains reflected the positive impact of Kentucky Fried Chicken's (KFC) operations since its acquisition in October 1986. During that period KFC's domestic per store average sales demonstrated strong growth. Excluding KFC, 1986 net sales advanced 15 percent over 1985 while segment operating profits declined four percent.

The following discussion focuses on comparisons excluding the impact of KFC.

The significant growth in segment sales was due primarily to the addition of new restaurants and pizza delivery units. For the year, per store average sales at domestic company-owned Pizza Hut and Taco Bell restaurants rose one percent. Sales trends were improving in the fourth quarter of 1986 as per store average sales increased by five percent. Pizza Hut's sales growth in 1986 primarily reflected additional restaurants and delivery units and moderate pricing actions. Taco Bell sales rose substantially as a result of significant new restaurant additions. Strong foreign sales in 1986 reflected higher volumes in Australia and Canada.

The decline in 1986 operating profits in the restaurants segment primarily reflected increased start-up losses related to Pizza Hut Delivery operations, partially offset by an improvement in other restaurant operations and higher gains resulting from the sale of company-owned restaurants.

Operating profits at Pizza Hut were down slightly from 1985, with gains from volume increases and lower food costs offset by higher home delivery losses. Taco Bell profits were up due to strong volume gains and lower food costs, partially offset by higher expenses resulting from more units and improvements to existing units.

Gains resulting from the sale of company-owned restaurants represented 10 percent of the restaurants segment operating profits in 1986 and five percent in 1985.

Foreign operating profits were down reflecting increased promotional and new market development costs.

1985 vs. 1984

Net sales advanced 14 percent in 1985, primarily due to new restaurant units, new products and pricing. Per store average sales of domestic company-owned Pizza Hut and Taco Bell restaurants rose five percent.

Operating profits advanced eight percent, due to increased profits in both domestic and foreign operations.

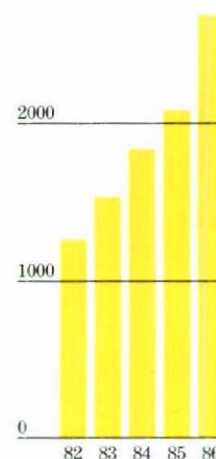
Pizza Hut growth reflected lower food costs and improved control of operating expenses, partially offset by start-up costs associated with Pizza Hut's expanding test of its home delivery concept. Higher operating costs at Taco Bell from increased investments in new product development and new and existing stores were offset by a gain from the sale of its former office building.

Gains resulting from the sale of company-owned restaurants amounted to less than five percent of the restaurants segment operating profits in 1984. Foreign operating profits improved considerably in 1985 from a small base in 1984.

Net Sales

(\$ In Millions)

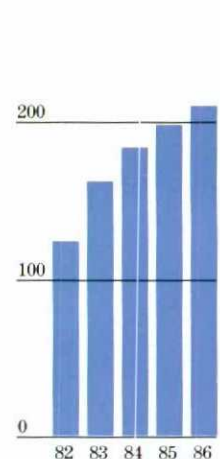
3000



Operating Profits

(\$ In Millions)

300



Contents

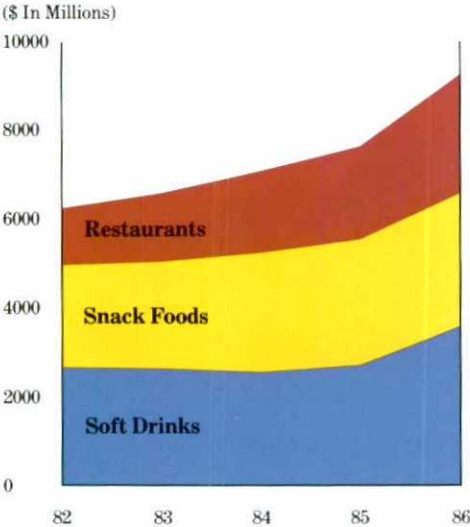
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Note: For Management's Analysis of business segment operating results see pages 17, 23 and 30.

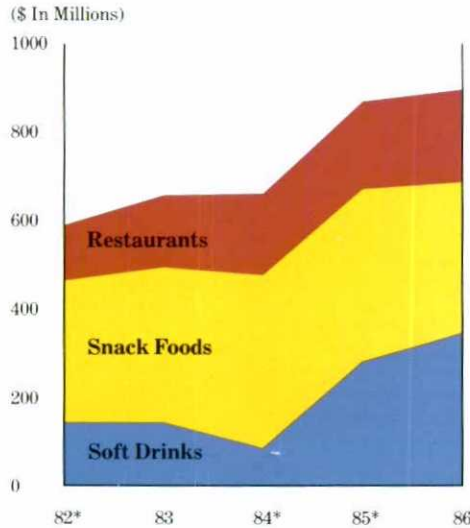
In 1986 PepsiCo became the 24th U.S. corporation to list on the Tokyo Stock Exchange.

Business Segments

Net Sales



Operating Profits



* Includes impact of unusual charges and credit related to foreign bottling operations. See pages 42 and 48.

PepsiCo operates within three distinct business segments on a worldwide basis: soft drinks, snack foods and restaurants. Management's discussion and analysis of PepsiCo's business segments appears on pages 17, 23 and 30 under Management's Analysis.

The soft drinks segment primarily manufactures and markets Pepsi-Cola, Slice and their allied brands worldwide and Seven-Up internationally. For purposes of this Note, the operations of the soft drink concentrate manufacturing facility in Puerto Rico are allocated between domestic and foreign based upon the actual concentrate shipments to the respective markets. The snack foods segment primarily manufactures and markets salty snacks. The restaurants segment primarily includes the operations of Pizza Hut, Taco Bell and Kentucky Fried Chicken. The 1986 soft drinks and restaurants segment data included the results of the soft drink business of MEI Corporation, the international franchise soft drink business of The Seven-Up Company and Kentucky Fried Chicken operations from their respective dates of acquisition (see Note to the Consolidated Financial Statements on page 41).

In 1986 PepsiCo made three reclassifications to conform the reporting of segment net sales and operating profits to industry practices. Certain promotional discounts previously included in the soft drinks segment as marketing expense were reclassified as a reduction of net sales. State income taxes and net foreign currency translation gains previously included in the determination of segment operating profits were excluded and reclassified to "Provision for income taxes" and "Corporate expenses, net," respectively. The 1985 and 1984 amounts were reclassified on a comparable basis.

In December 1986 the Securities and Exchange Commission issued guidelines that clarified the reporting of certain unusual items. As a result, soft drinks segment operating profits were restated to include a \$26 million credit recorded in 1985 and a \$156 million charge recorded in 1984 related to the sale of several foreign company-owned bottling operations (see Note to the Consolidated Financial Statements on page 42).

Operating profits included research and development expenses of \$82 million, \$66 million and \$49 million in 1986, 1985 and 1984, respectively.

Corporate expenses included unallocated corporate items, net interest expense and net foreign currency translation gains, which arose principally from the translation of foreign local currency borrowings. These foreign exchange translation gains were \$33 million, \$32 million and \$53 million in 1986, 1985 and 1984, respectively.

Corporate identifiable assets principally consisted of short-term investments. Included in 1985 were the receivable from the sale of North American Van Lines and the investment in the Allegheny Pepsi-Cola Bottling Company, and in 1985 and 1984, the investment in Safe Harbor leases.

	1986	1985	1984
Net Sales:			
Soft drinks	\$3,588.4	2,725.1	2,565.0
Snack foods	3,018.4	2,847.1	2,709.2
Restaurants	2,684.0	2,081.2	1,833.4
Total continuing operations	\$9,290.8	7,653.4	7,107.6
Foreign portion	\$1,225.8	951.9	963.9

Operating Profits:

Soft drinks	\$ 348.6	283.4	86.6
Snack foods	342.8	392.5	393.9
Restaurants	210.1	198.1	183.8
Corporate expenses, net	(221.2)	(202.4)	(213.5)
Income from continuing operations before income taxes	\$ 680.3	671.6	450.8
Foreign portion	\$ 64.7	70.0	(139.9)

Capital Spending:

Soft drinks	\$ 193.9	160.7	83.6
Snack foods	298.6	286.3	188.9
Restaurants	384.6	331.0	252.5
Corporate	9.2	7.9	30.8
Total continuing operations	\$ 886.3	785.9	555.8
Foreign portion	\$ 81.4	67.3	36.4

Identifiable Assets:

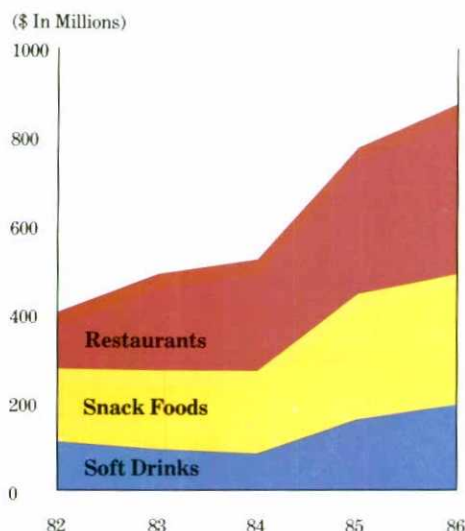
Soft drinks	\$2,617.7	1,318.6	1,038.9
Snack foods	1,603.8	1,487.1	1,254.5
Restaurants	2,659.5	1,326.7	1,020.7
Corporate	1,147.6	1,760.5	1,277.0
Total continuing operations	\$8,028.6	5,892.9	4,591.1
Foreign portion	\$2,275.0	1,054.3	687.5

Depreciation and Amortization Expense:

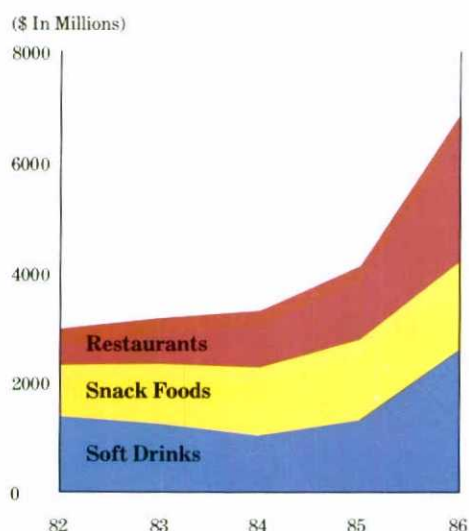
Soft drinks	\$ 104.3	69.2	71.1
Snack foods	135.3	107.7	93.6
Restaurants	156.4	109.2	75.7
Corporate	4.7	4.7	9.2
Total continuing operations	\$ 400.7	290.8	249.6
Foreign portion	\$ 36.3	25.3	36.8

This information constitutes a Note to the Consolidated Financial Statements.

Capital Spending



Identifiable Assets



Consolidated Statement of Income

(in millions except per share amounts)

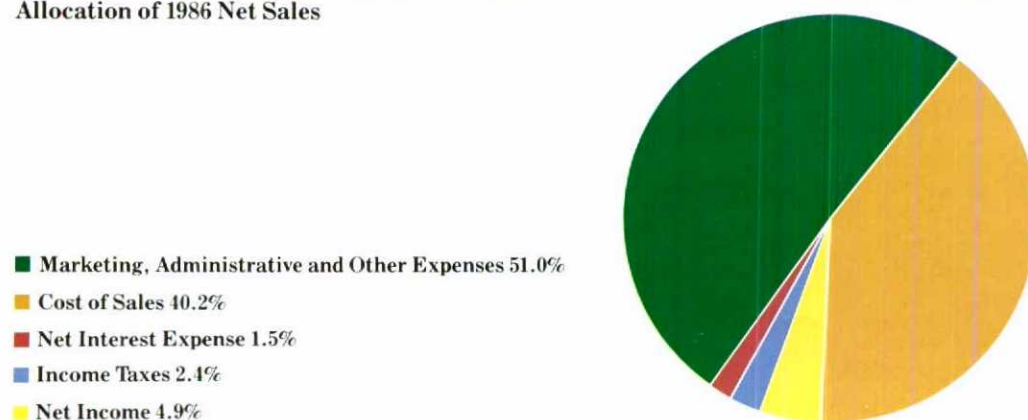
PepsiCo, Inc. and Subsidiaries

Fifty-two weeks ended December 27, 1986, December 28, 1985 and December 29, 1984

	1986	1985	1984
Net Sales	\$9,290.8	\$7,653.4	\$7,107.6
Costs and Expenses			
Cost of sales	3,731.8	3,148.3	2,974.4
Marketing, administrative and other expenses	4,738.4	3,760.4	3,407.4
Refranchising (credit) charge	—	(25.9)	156.0
Interest expense	263.2	195.4	205.1
Interest income	(122.9)	(96.4)	(86.1)
	<u>8,610.5</u>	<u>6,981.8</u>	<u>6,656.8</u>
Income From Continuing Operations Before Income Taxes	680.3	671.6	450.8
Provision for Income Taxes	222.5	251.5	175.8
Income From Continuing Operations	457.8	420.1	275.0
Discontinued Operations			
Income (loss) from discontinued operations (net of income tax provision of \$6.7 in 1985 and none in 1984)	—	9.6	(47.5)
Gain (loss) on disposals (net of income tax provision of \$28.8 in 1985 and benefit of \$1.0 in 1984)	—	114.0	(15.0)
	<u>—</u>	<u>123.6</u>	<u>(62.5)</u>
Net Income	\$ 457.8	\$ 543.7	\$ 212.5
Income (Loss) Per Share			
Continuing operations	\$1.75	\$1.50	\$.97
Discontinued operations	—	.44	(.22)
Net Income Per Share	\$1.75	\$1.94	\$.75
Average shares outstanding used to calculate income per share	262.2	280.7	287.5

See accompanying Notes to Consolidated Financial Statements.

Allocation of 1986 Net Sales



Management's Analysis-Results of Continuing Operations

The Consolidated Statement of Income includes the results of operations of Kentucky Fried Chicken, MEI Corporation and Seven-Up International (the Acquisitions) from their respective dates of acquisition. The Acquisitions reflect PepsiCo's strategy to expand our leadership role within our three existing business segments, and in 1986 they contributed significantly to the increases in sales, operating expenses and interest expense. The estimated net impact of the Acquisitions was a reduction of \$.05 in 1986 income per share from continuing operations.

Net Sales

Net sales rose 21 percent in 1986, compared to an eight percent increase in 1985. The 1986 increase excluding the Acquisitions was 12 percent, reflecting domestic soft drink gains led by Diet Pepsi and Slice flavors, a substantial increase in the number of restaurant and pizza delivery units and the success of Frito-Lay's core brand line extension strategy. The 1985 improvement was driven by volume gains, primarily attributable to Slice and other new products, new restaurants and strong Diet Pepsi growth.

Costs and Expenses

Cost of sales as a percent of net sales has declined during the past three years from 41.8 percent in 1984 to 41.1 percent in 1985 and 40.2 percent in 1986, reflecting an increase in higher margin restaurant sales as a percentage of PepsiCo's total sales. Product costs also benefited from favorable snack food ingredient and restaurant food costs in 1986 and 1985.

Marketing, administrative and other expenses rose 26 percent in 1986, compared to a 10 percent increase in 1985. The 1986 increase excluding the Acquisitions was 16 percent, reflecting higher selling expenses associated with Frito-Lay's new product and selling strategies and costs related to new restaurant and pizza delivery units. Also reflected in other expenses in 1986 were a \$52 million charge by Frito-Lay related to the discontinuance of certain non-salty snack products and a reduction in cookie production capacity, and a \$22 million credit arising from the favorable impact of the U.S. Tax Reform Act of 1986 on PepsiCo's Safe Harbor leases. The 1985 increase in these expenses was attributable to higher competitive spending in domestic soft drinks and promotional spending for new products in all segments.

Refranchising (credit) charge relates to PepsiCo's Refranchising Program to sell several foreign company-owned bottling operations to independent franchised bottlers. (See Note to the Consolidated Financial Statements on page 42.)

Net interest expense (after deducting interest income) increased 42 percent in 1986, following a 17 percent decrease in 1985. The significant rise in 1986 was primarily due to higher domestic levels of debt used to finance the Acquisitions and share repurchases. The increase was somewhat moderated by lower domestic and foreign interest rates and interest income gains from higher levels of short-term investments.

The decrease in net interest expense in 1985 was attributable to a reduction in foreign borrowings related to bottling operations in the Refranchising Program, and increased interest income, partially offset by higher commercial paper borrowings used to finance share repurchases and the acquisition of the Allegheny Pepsi-Cola Bottling Company.

Income From Continuing Operations Before Income Taxes

Income from continuing operations before income taxes increased one percent in 1986 and 49 percent in 1985. Excluding the refranchising (credit) charge, income advanced five percent in 1986 and six percent in 1985. The 1986 results reflected strong profit advances in the soft drinks segment, the gain related to Safe Harbor leases and a \$19 million gain (including interest income of \$11 million) which arose from the collection of a foreign soft drink receivable written off in 1978, partially offset by the Frito-Lay charge and increased interest expense. The 1985 results reflected profit gains in the restaurants and soft drinks segments and reduced interest expense.

Provision for Income Taxes

The effective tax rate on income from continuing operations was 32.7 percent, 37.4 percent and 39.0 percent in 1986, 1985 and 1984, respectively. The declines principally reflected an increase in the percentage of foreign earnings taxed at rates below the U.S. federal statutory tax rate of 46 percent. The effective tax rate in 1986 benefited from an \$18 million adjustment to the deferred foreign provision, reflecting management's decision to indefinitely reinvest certain unremitted prior years' foreign earnings.

Income From Continuing Operations

Income from continuing operations advanced nine percent in 1986 and 53 percent in 1985. Excluding the refranchising (credit) charge, income rose 13 percent in 1986 and 20 percent in 1985. Income excluding the refranchising (credit) charge as a percent of net sales was 4.9 percent, 5.3 percent and 4.7 percent in 1986, 1985, and 1984, respectively. The decrease in 1986 was primarily a result of the significant increase in interest expense partially offset by the lower effective tax rate. The improved rate in 1985 reflected reductions in both interest expense and the effective tax rate. Including the refranchising (credit) charge, income from continuing operations as a percent of net sales was 5.5 percent in 1985 and 3.9 percent in 1984.

Income Per Share

Income per share from continuing operations rose 17 percent to \$1.75 from \$1.50 in 1985, with an estimated \$.07 of the growth attributable to the share repurchases. In 1985 income per share from continuing operations increased \$.53 or 55 percent from \$.97 in 1984. Excluding the effects of the refranchising (credit) charge, 1985 income per share from continuing operations rose 22 percent.

Consolidated Statement of Financial Condition

(in millions except per share amount)

PepsiCo, Inc. and Subsidiaries

December 27, 1986 and December 28, 1985

	1986	1985
Assets		
Current Assets		
Cash	\$ 34.9	\$ 26.0
Short-term investments	885.6	912.9
	<u>920.5</u>	<u>938.9</u>
Receivable from sale of North American Van Lines	—	375.5
Notes and accounts receivable, less allowance: 1986-\$43.2, 1985-\$30.4	820.2	653.3
Inventories	431.5	380.1
Prepaid expenses, taxes and other current assets	331.6	478.0
	<u>2,503.8</u>	<u>2,825.8</u>
Long-term Receivables, Investments and Other Assets	400.1	309.6
Property, Plant and Equipment	3,840.1	2,571.8
Goodwill	1,284.6	185.7
	<u>\$8,028.6</u>	<u>\$5,892.9</u>
Liabilities and Shareholders' Equity		
Current Liabilities		
Notes payable	\$ 232.7	\$ 344.1
Accounts payable	858.9	623.7
Income taxes payable	195.2	150.0
Other current liabilities	936.3	738.2
	<u>2,223.1</u>	<u>1,856.0</u>
Long-term Debt	2,492.9	1,035.6
Capital Lease Obligations	139.7	127.1
Other Liabilities and Deferred Credits	336.2	222.8
Deferred Income Taxes	777.6	813.7
Shareholders' Equity		
Capital stock, par value 1 2/3¢ per share: authorized 600.0 shares, issued 287.7 shares	4.8	4.8
Capital in excess of par value	287.0	282.5
Retained earnings	2,356.6	2,061.4
Cumulative translation adjustment	(40.0)	(40.9)
Cost of treasury stock: 1986-27.4 shares, 1985-24.6 shares	(549.3)	(470.1)
	<u>2,059.1</u>	<u>1,837.7</u>
	<u>\$8,028.6</u>	<u>\$5,892.9</u>

See accompanying Notes to Consolidated Financial Statements.

Management's Analysis—Financial Condition

PepsiCo's overriding corporate objective is to maximize shareholder value while maintaining a strong financial position. This objective is achieved by allocating financial resources to businesses and investments that yield attractive long-term returns while optimizing our capital structure to reduce the overall cost of capital.

A major strategy to achieve these goals has been the redeployment of assets from nonstrategic or underperforming businesses into our three large and highly profitable business segments. This was evidenced by the 1984 and 1985 dispositions of Lee Way, North American Van Lines (NAVL), Wilson and several of our foreign company-owned bottling operations, followed by the 1986 acquisitions of MEI Corporation, Seven-Up International and Kentucky Fried Chicken (the Acquisitions). The 1985 and 1986 share repurchases, which represented another strategy to maximize shareholder value, resulted in increased income per share from continuing operations and return on shareholders' equity.

Assets

As a result of our strategic actions, PepsiCo's total assets of \$8 billion, a 36 percent increase over 1985, are now invested in our three high-return business segments. The increase in total assets reflects our continuing investment in operations and the impact of the Acquisitions on goodwill and property, plant and equipment. Current assets decreased by 11 percent as the effect of the Acquisitions was more than offset by the 1986 collection of the receivable from the sale of NAVL and the consolidation of Allegheny Pepsi-Cola Bottling Company.

Cash and short-term investments declined slightly in 1986, reversing the growth of recent years. This decline was partially due to the use of certain offshore short-term investment portfolios to fund the foreign portion of the Acquisitions. PepsiCo's portfolio in Puerto Rico, which represents the bulk of short-term investments, continued to grow as a result of strong operating cash flows from our soft drink concentrate manufacturing facility located there.

Property, plant and equipment increased by almost 50 percent, reflecting continued heavy investment in our businesses and the significant impact of the Acquisitions. Purchases of property, plant and equipment rose to \$886 million in 1986 compared to \$786 million in the prior year. In both years our fast-growing restaurants segment accounted for the largest portion of the capital additions.

The substantial increase in goodwill represents the excess of the aggregate purchase price over the fair value of net assets acquired primarily in the Acquisitions.

Liabilities

Current liabilities rose 20 percent, reflecting growth in our operations and the impact of the Acquisitions.

Long-term debt increased by almost \$1.5 billion in 1986, as PepsiCo leveraged its financial strength to fund the Acquisitions and share repurchases. During 1986 PepsiCo issued approximately \$1.1 billion of long-term debt in a variety of currencies. In conjunction with certain debt issuances, PepsiCo entered into interest rate swap or currency exchange agreements which effectively converted the majority of the under-

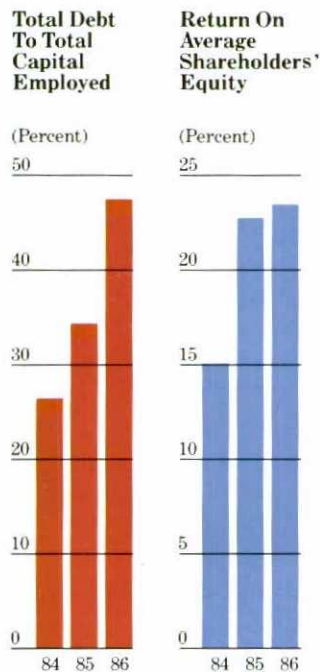
lying debt to variable interest rate U.S. dollar debt. These agreements effectively eliminate foreign currency exchange exposure on the underlying borrowings and reflect our current assessment of credit market conditions while facilitating management of our capital structure to minimize financing costs.

Financial Leverage

PepsiCo measures leverage on both a gross and net basis to take into account our sizeable short-term investment portfolios. On a gross basis, PepsiCo's ratio of total debt (including capital lease obligations) to capital employed (total debt, deferred income taxes, other liabilities and deferred credits and shareholders' equity) increased to 47.5 percent at year-end 1986 from 34.4 percent at year-end 1985. Leverage on a net basis, which reflects the pro forma remittance of off-shore short-term investments as a reduction of total debt, was approximately 40 percent and 24 percent at year-end 1986 and 1985, respectively. The increase in the ratios primarily reflected the higher debt levels in 1986.

Shareholders' Equity

Return on average shareholders' equity, based on income from continuing operations, rose to 23.5 percent in 1986 from 22.8 percent and 15.1 percent in 1985 and 1984, respectively. The 1986 increase reflects the growth in income from continuing operations and the positive impact of the share repurchase program. Excluding the refranchising (credit) charge, the return on average shareholders' equity was 21.7 percent in 1985 and 18.2 percent in 1984.



Consolidated Statement of Changes in Financial Condition

(in millions)

PepsiCo, Inc. and Subsidiaries

Fifty-two weeks ended December 27, 1986, December 28, 1985 and December 29, 1984

	1986	1985	1984
Cash was Generated by (Used for):			
Continuing operations:			
Income	\$ 457.8	\$ 420.1	\$ 275.0
Depreciation and amortization	400.7	290.8	249.6
Deferred income taxes	54.0	81.1	121.3
Other noncash charges and credits, net	84.4	95.8	85.4
Refranchising (credit) charge	—	(14.9)	62.0
Changes in operating working capital accounts (see details below)	234.4	(53.0)	188.2
Cash generated by continuing operations	1,231.3	819.9	981.5
Cash generated by (used for) discontinued operations	—	1.4	(1.0)
Investment activities:			
Acquisitions	1,678.3	160.0	—
Purchases of property, plant and equipment	886.3	785.9	555.8
Receivable from sale of North American Van Lines	(375.7)	375.5	—
Proceeds from sale of North American Van Lines	—	(369.0)	—
Proceeds from sales of property, plant and equipment	(45.5)	(49.4)	(42.2)
Proceeds from sale of Wilson Sporting Goods	—	(134.1)	—
Other, net7	4.5	26.8
Cash used for investment activities	2,144.1	773.4	540.4
Financing activities*:			
Increase in long-term debt and capital lease obligations	1,371.1	689.9	41.4
Cash dividends declared	(162.6)	(161.2)	(156.2)
(Decrease) increase in notes payable	(159.9)	63.3	5.5
Purchase of treasury stock	(158.0)	(458.2)	—
Issuance of capital stock	83.2	51.5	11.3
Safe Harbor leases	(1.1)	114.0	115.6
Reduction in long-term debt and capital lease obligations	(78.3)	(220.5)	(197.9)
Cash generated by (used for) financing activities	894.4	78.8	(180.3)
Resulting in:			
(Decrease) increase in cash and short-term investments during the year	\$ (18.4)	\$ 126.7	\$ 259.8
Details of Changes in Operating Working Capital Accounts Which Generated (Used) Cash*:			
Notes and accounts receivable	\$ (48.7)	\$ (65.9)	\$ (45.0)
Inventories	24.2	(39.4)	(81.0)
Prepaid expenses, taxes and other current assets	27.7	(125.1)	17.8
Accounts payable	126.5	136.2	130.5
Income taxes payable	29.9	.5	58.9
Other current liabilities	74.8	40.7	107.0
	\$ 234.4	\$ (53.0)	\$ 188.2

*Does not include amounts related to Acquisitions (at the dates of acquisition), divestitures and discontinued operations.

See accompanying Notes to Consolidated Financial Statements.

Management's Analysis—Changes in Financial Condition

Nineteen eighty-six was a record year in terms of cash flow generated by operations as well as investment and financing activities. PepsiCo generated \$1.2 billion in cash from operations which, when combined with net financing of \$894 million and the collection of the \$376 million NAVL receivable, funded acquisitions of \$1.7 billion and capital expenditures of \$886 million.

Cash Generated by Continuing Operations

PepsiCo's ability to generate funds internally continues to be one of its most significant financial strengths. Cash generated by continuing operations has averaged slightly above \$1 billion per year over the past three years, and on a cumulative basis, has been sufficient to fund record purchases of property, plant and equipment (PP&E) and dividends in that time period.

Cash Generated by Continuing Operations vs. Purchases of PP&E and Dividends Declared

(\$ In Millions)

1500

1000

500

0

84

85

86

■ Cash Generated
■ PP&E Purchased
■ Dividends Declared

Cash generated by continuing operations in 1986 increased 50 percent or \$411 million over 1985. Approximately \$124 million of the growth resulted from higher income after adjustments for noncash items. The remaining increase related to changes in operating working capital, reflecting a reduction in inventories and prepaid taxes in 1986 and the initial prefunding of certain employee benefit plans in 1985. In 1985 cash generated by continuing operations decreased 16 percent from 1984 as an increase in income adjusted for noncash items was more than offset by an increase in operating working capital.

Investment Activities

PepsiCo's investment activities in 1986 reflected significant expenditures related to our growth strategies, which include our commitment to support all three business segments through acquisitions and appropriate investments in property, plant and equipment. In 1984 and 1985 PepsiCo divested several nonstrategic or underperforming businesses and acquired

Allegheny Pepsi-Cola Bottling Company. Major acquisition and divestiture activities are described on pages 41 and 42 of Notes to Consolidated Financial Statements.

Investments in property, plant and equipment form the cornerstone of PepsiCo's strategy to invest in its businesses to provide for consistent future growth in earnings and operating cash flows. Capital spending is expected to increase in 1987, as our continuing commitment to grow all our businesses is extended to the recent acquisitions.

Financing Activities

The 1986 increase in cash generated by financing activities reflected a significant net increase in long-term debt to finance the 1986 acquisitions and share repurchases. Under the share repurchase program approved by PepsiCo's Board of Directors in 1985, PepsiCo Capital Stock repurchases totaled 22 million shares at an aggregate cost of \$458 million in 1985, and 6.7 million shares at an aggregate cost of \$158 million in 1986.

At year-end 1985 PepsiCo had \$603 million of commercial paper which was classified as long-term debt and subsequently refinanced in 1986, through the issuance of long-term debt. At year-end 1986 PepsiCo had \$837 million of commercial paper and \$85 million of Euro-Medium-Term notes due in 1987 which were classified as long-term debt as these amounts are intended to be refinanced on a long-term basis in 1987.

At year-end 1986 and 1985, PepsiCo had unused credit facilities approximating \$1.5 billion, providing domestic and international credit availability and support for the long-term classification of commercial paper and Euro-Medium-Term notes due in 1987.

PepsiCo declared record cash dividends of \$163 million in 1986, while retaining sufficient earnings to enhance productive capability and to provide adequate financial resources for growth opportunities.

U.S. Tax Reform Act of 1986 (TRA)

In 1981 and 1982 PepsiCo invested a total of \$429 million in Safe Harbor leases. The leases are effectively financing transactions that decrease income taxes payable over the initial years of the leases and increase them over the later years. On a cumulative basis, the leases generated approximately \$715 million of cash benefits through 1986. During 1986 the cash savings began to reverse and taxes payable will increase through 2005. As a result of reduced future tax rates under the TRA, taxes payable related to the leases will be reduced by \$90 million in 1987 and beyond. Based on these new rates, the cash outlays related to the leases will total an estimated \$271 million from 1987 through 2005.

The TRA will favorably affect income from continuing operations in 1987 and beyond, but because of PepsiCo's mix of domestic and foreign income and repeal of the investment tax credit, the effect will be less than the actual decline in the U.S. federal statutory tax rate. The TRA is expected to have a modest impact on PepsiCo's annual cash flow.

Consolidated Statement of Shareholders' Equity

(shares in thousands, dollars in millions, except per share amounts)

PepsiCo, Inc. and Subsidiaries

Fifty-two weeks ended December 27, 1986, December 28, 1985 and December 29, 1984

	Capital Stock				Capital in Excess of Par Value	Retained Earnings	Cumulative Translation Adjustment	Total
	Issued		Treasury					
	Shares	Amount	Shares	Amount				
Shareholders' Equity, December 31, 1983..	284,958	\$4.8	(4,278)	\$ (37.2)	\$245.0	\$1,622.6	\$(41.0)	\$1,794.2
1984 Net income						212.5		212.5
Cash dividends declared (per share—\$0.56)						(156.2)		(156.2)
Shares reissued to PAYSOP			507	4.4	2.5			6.9
Payment of compensation awards and exercise of stock options	510				4.2			4.2
Conversion of debentures	24				.2			.2
Translation adjustments (net of income taxes of \$18.7)							(8.1)	(8.1)
Amount included in refranchising charge (net of income taxes of \$44.5)							(.3)	(.3)
Shareholders' Equity, December 29, 1984..	285,492	4.8	(3,771)	(32.8)	251.9	1,678.9	(49.4)	1,853.4
1985 Net income						543.7		543.7
Cash dividends declared (per share—\$0.59)						(161.2)		(161.2)
Shares reissued to PAYSOP			227	4.0	.5			4.5
Payment of compensation awards and exercise of stock options	468		75	1.3	5.5			6.8
Conversion of debentures	1,734		898	15.6	24.6			40.2
Translation adjustments (net of income taxes of \$0.1)							8.5	8.5
Purchase of treasury stock			(22,005)	(458.2)				(458.2)
Shareholders' Equity, December 28, 1985..	287,694	4.8	(24,576)	(470.1)	282.5	2,061.4	(40.9)	1,837.7
1986 Net income						457.8		457.8
Cash dividends declared (per share—\$0.63)						(162.6)		(162.6)
Shares reissued to PAYSOP			173	3.5	1.1			4.6
Payment of compensation awards and exercise of stock options			577	11.6	(2.4)			9.2
Conversion of debentures			1,421	28.5	.1			28.6
Translation adjustments (net of income taxes of \$0.6)9	.9
Purchase of treasury stock			(6,725)	(158.0)				(158.0)
Shares issued in connection with an acquisition			1,755	35.2	5.7			40.9
Shareholders' Equity, December 27, 1986..	287,694	\$4.8	(27,375)	\$(549.3)	\$287.0	\$2,356.6	\$(40.0)	\$2,059.1

See accompanying Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

(in millions except share amounts)

Summary of Significant Accounting Policies

Principles of Consolidation. The financial statements reflect the consolidated accounts of PepsiCo, Inc. and its wholly-owned subsidiaries and certain joint ventures controlled by Kentucky Fried Chicken. All significant intercompany accounts and transactions were eliminated. Certain reclassifications were made to 1985 and 1984 amounts to conform with the 1986 presentation.

Short-term Investments. Short-term investments are stated at cost, which approximates market, and included time deposits of \$392 million and \$269 million at year-end 1986 and 1985, respectively, and secured interests in pools of short-term discounted third-party receivables of \$203 million at year-end 1985.

Goodwill. Goodwill represents the excess of cost over identifiable net assets of companies acquired and is amortized over appropriate periods, not exceeding 40 years. The amount of goodwill included in the Consolidated Statement of Financial Condition is reviewed periodically and adjusted as appropriate. Goodwill amortization included in income from continuing operations before income taxes in 1986, 1985 and 1984 was \$25 million, \$8 million and \$10 million, respectively.

Marketing Costs. Costs of advertising and other marketing and promotional programs are charged to expense during the year, generally in relation to sales, and except for materials in inventory and prepayments, are substantially expensed in the year in which incurred. Certain discounts related to promotional programs in the soft drinks segment, which were previously included in the Consolidated Statement of Income under the caption "Marketing, administrative and other expenses," have been reclassified as a reduction of "Net Sales" for all periods presented. This reclassification conforms to PepsiCo's presentation to industry practice.

Net Income Per Share. Net income per share is computed by dividing net income (adjusted for interest expense related to certain convertible debentures) by the average number of shares and share equivalents outstanding during each year. The conversion of all convertible debentures would not result in a material dilution. All share amounts in the accompanying Consolidated Financial Statements and Notes have been restated to reflect the May 7, 1986 three-for-one stock split.

Acquisitions

In May 1986 PepsiCo acquired the soft drink business of MEI Corporation (MEI), PepsiCo's third largest independent bottler, for approximately \$591 million in cash.

In July 1986 PepsiCo acquired the international franchise soft drink business and two Canadian soft drink bottling operations of The Seven-Up Company (Seven-Up International) from Philip Morris Companies Inc. for approximately \$246 million in cash. As it is management's intention to resell the Canadian bottling operations to independent franchised bottlers, the estimated net realizable value of these operations has been accounted for as a temporary investment and included in the preliminary combined purchase price allocation below under the caption "Current assets."

In October 1986 PepsiCo acquired the Kentucky Fried Chicken operations (KFC) from RJR Nabisco, Inc. for approximately \$841 million in cash.

The acquisitions of MEI, Seven-Up International and KFC have been accounted for by the purchase method, and the purchase prices have been preliminarily allocated to the estimated fair value of the assets acquired and liabilities assumed. Any adjustments resulting from the final purchase price valuations are not expected to be material to the Consolidated Financial Statements of PepsiCo.

Preliminary combined purchase price allocation:

Current assets	\$ 261.7
Property, plant and equipment	825.6
Goodwill	945.4
Other noncurrent assets	104.1
Current liabilities	(265.8)
Long-term debt	(144.3)
Other noncurrent liabilities	(48.4)
	<u>\$1,678.3</u>

The unaudited pro forma combined results of PepsiCo, MEI, Seven-Up International and KFC, had the acquisitions occurred at the beginning of each of the periods presented, are provided in the following table. The pro forma information does not necessarily represent what the consolidated results would have actually been for 1986 and 1985 and is not intended to be indicative of future results.

	1986	1985
Net sales	\$10,621.6	\$9,426.2
Income from continuing operations	\$ 455.1	\$ 390.3
Per share	\$ 1.74	\$ 1.39
Net income	\$ 455.1	\$ 513.9
Per share	\$ 1.74	\$ 1.83

In May 1985 PepsiCo purchased the Allegheny Pepsi-Cola Bottling Company (Allegheny) for \$160 million in cash with the intent of selling the operations to independent franchised bottlers. Accordingly, in 1985 Allegheny was accounted for as a temporary investment and included in the Consolidated Statement of Financial Condition under the caption "Prepaid expenses, taxes and other current assets." Commencing with the third quarter of 1986, as a result of management's strategic decision to retain Allegheny, it has been accounted for by the purchase method and its operations have been consolidated. Allegheny's operations were not significant to the Consolidated Financial Statements of PepsiCo.

In 1986, 1985 and 1984, PepsiCo made several other acquisitions which collectively were not significant to the Consolidated Financial Statements of PepsiCo.

Refranchising (Credit) Charge

In 1984 PepsiCo recorded a \$156 million before-tax and \$62 million after-tax (\$.22 per share) charge reflecting the decision to sell several foreign company-owned bottling operations to independent franchised bottlers (the Refranchising Program). In 1985 a \$26 million before-tax and \$15 million after-tax (\$.05 per share) credit was recorded reflecting more favorable results from the Refranchising Program than originally anticipated.

As of year-end 1986 all but one of the company-owned foreign bottling operations in the Refranchising Program have been sold. The net liability arising from the Refranchising Program of \$54 million and \$53 million at year-end 1986 and 1985, respectively, was included in the Consolidated Statement of Financial Condition under the caption "Other current liabilities." The net liability included an accrual for estimated future operating and disposition losses related to the remaining bottling operation and other expenses arising from the Refranchising Program, less the net assets of the remaining bottling operation.

Discontinued Operations

In 1985 PepsiCo sold its Wilson Sporting Goods operation (Wilson) for \$134 million consisting of cash and Wilson 10 percent cumulative preferred stock. The loss on the sale of \$41 million before-tax and \$18 million after-tax (\$.06 per share) is subject to adjustment arising from a probable arbitration proceeding regarding the closing balance sheet of Wilson. Management believes any adjustment will not have a material effect on PepsiCo's business or financial condition.

The sale of North American Van Lines, Inc. (NAVL) was completed in 1985 for a \$369 million interest-bearing deferred payment due and subsequently received (including accrued interest) on January 2, 1986. The sale resulted in a gain of \$194 million before-tax and \$139 million after-tax (\$.50 per share).

The sale of Lee Way Motor Freight, Inc. (Lee Way) was completed in 1984 and resulted in a loss of \$16 million before-tax and \$15 million after-tax (\$.05 per share). In 1985 an additional loss of \$10 million before-tax and \$7 million after-tax (\$.03 per share) was recorded for payments made and costs incurred by PepsiCo under certain guarantees that existed at, or were entered into in connection with, the sale of Lee Way. The purchaser of Lee Way merged into Lee Way in 1985, shortly before filing for bankruptcy. The merged company is now in liquidation. PepsiCo has filed a claim to recover amounts paid or payable under the guarantees and claims have been asserted against PepsiCo by the purchaser and others. Although the outcome of all such claims and litigation is uncertain, management believes they will not have a material effect on PepsiCo's business or financial condition.

The 1985 gain on NAVL and loss on Wilson, and the 1984 and 1985 losses on Lee Way were reflected in the Consolidated Statement of Income under the caption "Gain (loss) on disposals." The effective tax rates on the gain (loss) from disposals in 1985 and 1984 were less than the U.S. federal statutory tax rate, reflecting the difference in the book and tax basis of the Capital Stock sold and the treatment of the sales as capital items.

The results of operations of Wilson, NAVL and Lee Way, through the dates in 1985 and 1984 on which the sales of the respective operations were recorded, were included in the Consolidated Statement of Income under the caption "Income (loss) from discontinued operations." Also included under this caption in 1984 was a \$64 million before-tax and \$59 million after-tax (\$.21 per share) charge related to Wilson, primarily representing the write-off of goodwill of \$54 million. The effective tax rates on income (loss) from discontinued operations were less than the U.S. federal statutory tax rate, reflecting the amortization of investment tax credits in 1985 and the write-off of the Wilson goodwill without tax benefit in 1984.

The results of Wilson, NAVL and Lee Way through their respective dates of sale were:

	1985	1984
Net sales and operating revenues	\$422.2	\$ 976.9
Costs and expenses	404.8	1,021.5
Net interest expense	1.1	2.9
	<u>405.9</u>	<u>1,024.4</u>
Income (loss) before income taxes	16.3	(47.5)
Income tax provision	6.7	—
Income (loss) from discontinued operations	<u>\$ 9.6</u>	<u>\$ (47.5)</u>

Income Taxes

Income from continuing operations before income taxes:

	1986	1985	1984
U.S.	\$387.9	\$448.2	\$516.7
Foreign	<u>292.4</u>	<u>223.4</u>	<u>(65.9)</u>
	<u>\$680.3</u>	<u>\$671.6</u>	<u>\$450.8</u>

PepsiCo has soft drink concentrate manufacturing facilities in Puerto Rico and Ireland that operate under tax incentive grants that expire in 1991 and 1989, respectively. Consistent with the allocation for tax purposes, foreign income in the above table includes approximately 50 percent of the income arising from the sale of soft drink concentrate that is manufactured in Puerto Rico.

State income taxes, which were previously included in the Consolidated Statement of Income and Consolidated Statement of Financial Condition under the captions "Marketing, administrative and other expenses" and "Other current liabilities" have been reclassified for all periods presented to "Provision for income taxes" and "Income taxes payable," respectively.

Provision for income taxes on income from continuing operations:

	1986	1985	1984
Current – Federal.....	\$134.6	\$ 82.1	\$135.6
Foreign and state	30.2	14.1	26.7
Deferred – Federal.....	59.5	147.0	2.3
Foreign and state	<u>(1.8)</u>	<u>8.3</u>	<u>11.2</u>
	<u>\$222.5</u>	<u>\$251.5</u>	<u>\$175.8</u>

Deferred taxes were not provided on unremitted earnings of subsidiaries operating outside the United States that are intended to be indefinitely reinvested. These unremitted earnings aggregated approximately \$428 million, \$314 million and \$214 million at year-end 1986, 1985 and 1984, respectively, exclusive of amounts that if remitted in the future would result in little or no tax under current tax laws. In 1986 PepsiCo reduced the deferred foreign provision by \$18 million to reflect management's decision to indefinitely reinvest certain unremitted prior years' foreign earnings.

Deferred income tax expense on continuing operations arose from the following:

	1986	1985	1984
Depreciation	\$ 65.7	\$ 42.3	\$ 38.4
Refranchising Program	25.3	55.0	(51.6)
Financing transactions	10.9	6.1	21.5
Discontinued product costs	(23.6)	(5.3)	—
Deferral of investment tax credits	(13.6)	13.7	4.7
Prefunded employee benefits	(2.9)	31.3	—
Other, net	(4.1)	12.2	.5
	<u>\$ 57.7</u>	<u>\$155.3</u>	<u>\$ 13.5</u>

Aggregate deferred investment tax credits of \$66 million and \$80 million at year-end 1986 and 1985, respectively, were included in the Statement of Financial Condition under the caption "Deferred Income Taxes."

The current portion of deferred federal income taxes of \$124 million at year-end 1986 and \$194 million at year-end 1985 was included in the Consolidated Statement of Financial Condition under the caption "Prepaid expenses, taxes and other current assets."

Reconciliation of the U.S. federal statutory tax rate to PepsiCo's effective tax rate:

	1986	1985	1984
U.S. federal statutory tax rate	46.0%	46.0%	46.0%
State income taxes net of federal tax benefit	2.6	.6	1.6
Earnings in jurisdictions taxed at lower rates (principally Puerto Rico and Ireland)	(10.4)	(5.6)	(1.2)
Investment tax credits	(2.7)	(2.9)	(3.7)
Losses related to the Refranchising Program	—	(.2)	(4.9)
Deferred taxes no longer required on unremitted earnings	(2.6)	—	—
Other, net	(.2)	(.5)	1.2
Effective tax rate	<u>32.7%</u>	<u>37.4%</u>	<u>39.0%</u>

The U.S. Tax Reform Act of 1986 (TRA) had an insignificant impact on the 1986 provision for income taxes, principally because PepsiCo defers the benefits of investment tax credits. The TRA did impact the Safe Harbor leases in which PepsiCo invested in 1981 and 1982. These leases are effectively financing transactions that decrease income taxes payable over the

initial years of the leases and increase them over the later years of the leases. Under the TRA the lower corporate tax rates for 1987 and subsequent years reduced the deferred tax liability related to the leases by \$90 million and changed the previously estimated cost of the leases to an estimated gain. Accordingly, a \$22 million credit, representing the estimated gain (\$15 million) plus the amount of the previously estimated cost that was charged against income in prior years (\$7 million), was included in the Consolidated Statement of Income under the caption "Marketing, administrative and other expenses." Deferred income taxes payable arising from the leases of \$271 million and \$362 million at year-end 1986 and 1985, respectively, were included in the Consolidated Statement of Financial Condition under the caption "Deferred Income Taxes."

Inventories

Inventories are valued at the lower of cost (computed on the average, first-in, first-out or last-in, first-out method) or net realizable value. Inventories computed on the last-in, first-out (LIFO) method comprised 59 percent and 57 percent of inventories at year-end 1986 and 1985, respectively.

	1986	1985
Raw materials, supplies and in-process	\$251.0	\$223.1
Finished goods	190.2	163.3
Total (approximates current cost)	441.2	386.4
Excess of current cost over LIFO cost	(9.7)	(6.3)
	<u>\$431.5</u>	<u>\$380.1</u>

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation is calculated principally on a straight-line basis over the estimated useful lives of the assets. Interest capitalized as an additional cost of property, plant and equipment was \$11 million in 1986, \$13 million in 1985 and \$8 million in 1984.

	1986	1985
Land	\$ 413.3	\$ 250.7
Buildings	1,695.4	1,015.1
Machinery and equipment	3,058.7	2,361.8
Capital leases	191.8	170.9
Bottles and cases	29.9	25.0
	<u>5,389.1</u>	<u>3,823.5</u>
Accumulated depreciation and amortization	(1,549.0)	(1,251.7)
	<u>\$3,840.1</u>	<u>\$2,571.8</u>

Notes Payable and Long-term Debt

	1986	1985
Notes Payable		
Current maturities on long-term debt and capital lease obligations	\$ 31.8	\$ 25.3
Other notes payable, primarily to foreign banks	200.9	168.8
\$150 million 10 $\frac{1}{8}$ % notes due 1986.....	—	150.0
	<u>\$ 232.7</u>	<u>\$ 344.1</u>
Long-term Debt		
Commercial paper (5.9% and 8.0% weighted average interest rate at year-end 1986 and 1985, respectively) (A)	\$ 837.2	\$ 603.0
Zero coupon serial debentures, \$850 million due 1988-2012 (13.9% semi-annual yield to maturity)	102.4	89.4
\$100 million 8 $\frac{3}{8}$ % notes due 1991	99.3	—
\$100 million 7 $\frac{1}{4}$ % notes due 1991	99.6	—
Zero coupon notes, \$100 million due 1992 (14.4% semi-annual yield to maturity).....	49.1	42.8
\$200 million 7 $\frac{3}{8}$ % notes due 1993 (B)	200.7	—
Zero coupon notes, \$125 million due 1994 (14.1% semi-annual yield to maturity).....	47.1	41.1
8% convertible subordinated debentures due 1996 (C)	22.3	40.1
\$165 million 7 $\frac{5}{8}$ % notes due 1998 (B)	163.4	—
Euro-Medium-Term notes due 1987 to 1989 (\$154.7 million face amount, 6.4% weighted average interest rate at year-end 1986) (A)	152.8	—
Australian dollar 75 million 14 $\frac{1}{8}$ % notes due 1989 (D)	49.5	—
Australian dollar 50 million 13% notes due 1990 (D)	33.3	34.4
Canadian dollar 75 million 8 $\frac{3}{4}$ % notes due 1991 (B)	53.9	—
Italian lire 100 billion 10 $\frac{1}{2}$ % notes due 1991 (D)	73.5	—
Swiss franc 130 million 5 $\frac{1}{4}$ % bearer bonds due 1995 (D)	79.6	47.8
Swiss franc 400 million perpetual Foreign Interest Payment bonds (E)	206.8	—
Other (13.8% and 11.9% weighted average interest rate at year-end 1986 and 1985, respectively).....	222.4	137.0
Total long-term debt (F)(G)	<u>\$2,492.9</u>	<u>\$1,035.6</u>

(A) At year-end 1986 PepsiCo had revolving credit agreements aggregating \$1.5 billion covering potential borrowings through 1992. These unused credit facilities provide PepsiCo with the ability to refinance short-term borrowings and currently support the classification of \$837 million of commercial paper and \$85 million of Euro-Medium-Term notes due in 1987 as long-term debt, as it is PepsiCo's intent to refinance these amounts on a long-term basis in 1987.

(B) PepsiCo utilized interest rate swap agreements to effectively establish variable rates on certain of its long-term fixed rate debt (the fixed coupon interest rate is identified in the table). At year-end 1986 the agreements effectively established a year-end weighted average variable interest rate of 5.8 percent on \$418 million of debt.

(C) The convertible subordinated debentures are convertible at the option of the holder at a rate of approximately 79 shares for each one thousand dollars of principal. At year-end 1986, 1,763,388 shares were reserved for issuance upon conversion of the debentures.

(D) Foreign currency denominated debt has been valued in the Consolidated Statement of Financial Condition at year-end exchange rates. To hedge foreign currency exposure on such obligations, PepsiCo has entered into currency exchange agreements which effectively establish U.S. dollar denominated interest and principal obligations over the term of the underlying debt instruments. At year-end 1986 the currency exchange agreements effectively established U.S. dollar liabilities of \$50 million with a weighted average fixed interest rate of 11.0 percent and \$151 million with a weighted average variable interest rate of 6.6 percent.

(E) The coupon rate of the Swiss franc 400 million Foreign Interest Payment bonds is 7 $\frac{1}{2}$ percent through 1996. The principal of the bonds is payable in Swiss francs and the interest payments will be made in U.S. dollars at a fixed contractual exchange rate. At the end of each 10-year period after the issuance of the bonds: (i) PepsiCo will have the right to redeem the bonds at their face amount; (ii) the bondholders will have the right to cause PepsiCo to redeem the bonds at the lesser of their face amount or the Swiss franc equivalent of the U.S. dollar proceeds received at issuance (the proceeds amount); or (iii) if the bonds are not redeemed, the coupon rate will be adjusted based on the prevailing yield of 10-year U.S. Treasury Securities. As it is PepsiCo's intent not to redeem the bonds, the proceeds amount is the basis of the carrying value of the bonds in the Statement of Financial Condition.

(F) In 1984 PepsiCo issued \$104 million Deutsche mark denominated bearer bonds yielding 7 $\frac{1}{4}$ percent, due 1994. PepsiCo defeased the bonds by depositing higher yielding notes of the West German Government in an irrevocable trust established for the sole purpose of servicing the interest and principal on the bonds. The bonds and West German Government notes were offset in the Consolidated Statement of Financial Condition.

(G) Long-term debt is carried net of any related discount or premium and unamortized debt issuance costs. The annual maturities of long-term debt through 1991, excluding the commercial paper and Euro-Medium-Term notes to be refinanced in 1987, are: 1987-\$17.6 million; 1988-\$90.3 million; 1989-\$81.6 million; 1990-\$53.9 million; and 1991-\$357.3 million. The debt agreements include various restrictions, none of which is presently significant to PepsiCo.

Leases

PepsiCo and its subsidiaries have noncancelable commitments for rental of restaurant facilities, office space, plant and warehouse facilities, transportation equipment and other personal property under both capital and operating leases. Certain of these properties have been subleased to restaurant franchisees. Lease commitments on capital and operating leases expire at various dates through May of 2031.

Leased property under capital leases:

	1986	1985
Buildings	\$187.9	\$168.1
Machinery and equipment	3.9	2.8
	<u>191.8</u>	<u>170.9</u>
Accumulated amortization	(79.3)	(72.9)
	<u>\$112.5</u>	<u>\$ 98.0</u>

Future minimum lease commitments and sublease receivables under noncancelable leases:

	Commitments		Sublease Receivables	
	Capital	Operating	Direct Financing	Operating
1987	\$ 30.2	\$111.2	\$ (7.4)	\$ (8.7)
1988	28.8	95.5	(7.1)	(8.3)
1989	26.4	84.7	(6.8)	(7.9)
1990	25.1	76.3	(6.6)	(7.5)
1991	23.2	67.6	(6.5)	(7.1)
Later years	<u>133.3</u>	<u>460.8</u>	<u>(52.4)</u>	<u>(57.9)</u>
	<u>\$267.0</u>	<u>\$896.1</u>	<u>\$ (86.8)</u>	<u>\$ (97.4)</u>

The present value of minimum lease commitments for capital leases amounts to \$154 million after deducting \$1 million for estimated executory costs (taxes, maintenance and insurance) and \$112 million representing imputed interest. The present value of minimum sublease receivables amounts to \$40 million after deducting \$47 million of unearned interest income. Total rental expense for all operating leases for 1986, 1985 and 1984 was \$151 million, \$117 million and \$110 million, respectively. Total rental income from all operating subleases for 1986, 1985 and 1984 was \$17 million, \$16 million and \$15 million, respectively.

Employee Benefit Plans

PepsiCo has several noncontributory pension plans covering substantially all domestic employees (mostly nonunion). The total pension expense for all plans was approximately \$35 million, \$37 million and \$41 million in 1986, 1985 and 1984, respectively, which includes amortization of unfunded past service cost over 30 years for certain defined benefit plans. In 1985 PepsiCo changed actuarial cost methods for its pay-related plans from the Frozen Initial Liability method to the Projected Unit Credit method, reducing 1985 pension expense by approximately \$7 million.

PepsiCo estimates that pension expense for its domestic plans will be reduced by a minimum of \$35 million in 1987 when Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions, is adopted.

PepsiCo makes annual contributions to its pension plans equal to the minimum statutory requirement. As a result, \$34 million of the combined 1985 and 1984 accrued pension expense was not funded and PepsiCo does not currently expect to fund \$18 million of the 1986 accrued pension expense.

Estimated present value of accumulated plan benefits and net assets of domestic plans:

	January 1,	
	1986	1985
Vested	\$327.8	\$291.4
Nonvested	<u>91.1</u>	<u>85.8</u>
	<u>\$418.9</u>	<u>\$377.2</u>
Net assets available for plan benefits	<u>\$573.9</u>	<u>\$459.2</u>

The rate of return used in determining the actuarial present value of accumulated plan benefits was seven percent for both 1986 and 1985.

PepsiCo provides certain health care and life insurance benefits to retired nonunion employees. The annual costs of these benefits, which are not significant, are expensed as health care claims are incurred and life insurance premiums are paid.

Employee Stock Option and Ownership Plans

The shareholder-approved 1979 Incentive Plan (the Plan), which expires December 31, 1987, provides long-term incentives to certain key employees through grants of performance shares, stock options, stock appreciation rights (SARs) and incentive stock units. Under the Plan a maximum of 13.8 million shares of PepsiCo Capital Stock may be purchased or paid pursuant to grants by the Compensation Committee of the Board of Directors (the Committee) at prices not less than the fair market value at the date of grant. The Committee is composed of outside directors.

Performance shares and an equal number of stock options have been awarded to senior management employees. Each stock option represents the right to purchase one share of PepsiCo Capital Stock. The Committee sets the period during which an option may be exercised; however, none may be exercised until four years after the option is granted and may not have a term longer than 15 years from date of grant. Stock option activity for the years 1984 through 1986 was as follows:

	Option Exercise Prices	Shares Under Option
Balance, December 31, 1983	\$7.96 to \$14.35	2,235,276
1984		
Granted	\$12.33	1,579,770
Exercised	\$7.96 and \$8.04	(474,246)
Cancelled or surrendered for SARs	—	(711,387)
Balance, December 29, 1984	\$7.96 to \$14.35	2,629,413
1985		
Granted	\$11.56	4,464
Exercised	\$ 7.96	(304,644)
Cancelled or surrendered for SARs	—	(310,185)
Balance, December 28, 1985	\$11.56 to \$14.35	2,019,048
1986		
Granted	\$23.08 to \$32.06	1,113,211
Exercised	\$11.56	(384,169)
Cancelled or surrendered for SARs	—	(276,208)
Balance, December 27, 1986	\$11.56 to \$32.06	<u>2,471,882</u>

At year-end 1986 148,199 options for shares were exercisable and 9,215,103 shares were reserved for issuance under the Plan. In January 1987 1,200,000 options were issued at an exercise price of \$27.46 per share.

Each performance share is equivalent to one share of PepsiCo Capital Stock. Performance shares are not paid unless PepsiCo achieves income per share growth targets established by the Committee for the four-year period following the award. Upon determination by the Committee that a performance share has been earned, the holder receives the lesser of the fair market value of one share of Capital Stock at the date of award or the fair market value of one share of Capital Stock at the end of the award period. The performance share is paid in cash or Capital Stock or a combination thereof as determined by the Committee. During 1986 and 1984, 2,259,015 performance shares were awarded, of which 1,944,068 were outstanding at year-end 1986.

Stock appreciation rights (SARs) permit the holder of a stock option to surrender an exercisable option for an amount equal to the appreciation between the option exercise price and the fair market value of Capital Stock on the date the SAR is exercised or expires. The amount is paid in cash or Capital Stock or a combination thereof. SARs expire on the same dates as the related options. In 1986, 286,107 SARs were granted, and as of year-end 1986, 172,388 were outstanding.

Incentive stock units (Units) are awarded by the Committee as incentives to middle management employees. Each Unit entitles the holder to receive the value of a share of Capital Stock without payment of any amounts to PepsiCo or satisfaction of any corporate performance objectives. Each Unit is valued at the fair market value of the Capital Stock at the end of each vesting period. Currently, 30 percent of each award vests at the end of two years, an additional 30 percent vests at the end of four years, and the remainder vests at the end of six years. Payment of the Units is made in cash or Capital Stock or a combination thereof as determined by the Committee. From 1979 to 1986, 1,946,349 Units were awarded, of which 658,984 were outstanding at year-end 1986.

The estimated cost of all awards under the Plan is charged to expense over the applicable terms of the awards. The cost was \$17 million in 1986, \$19 million in 1985 and \$11 million in 1984.

During 1986 and 1985, PepsiCo made a tax creditable contribution of 173,137 and 226,620 shares of Capital Stock, respectively, to its Payroll-based Employee Stock Ownership Plan (PAYSOP).

Contingencies

PepsiCo is involved in various claims and legal proceedings, the resolution of which management believes will not have a material effect on PepsiCo's business or financial condition. PepsiCo intends to prosecute or defend vigorously, as the case may be, all such matters.

At year-end 1986 PepsiCo was contingently liable under direct and indirect guarantees aggregating \$64.1 million.

Report of Chief Financial Officer

To Our Shareholders:

Management is responsible for the integrity and objectivity of the financial statements and related notes. To meet this responsibility, we maintain a system of internal control, supported by formal policies and procedures, and an internal audit program designed to monitor and report on the adequacy of and compliance with our internal controls, policies and procedures. We believe the established system of internal control provides reasonable assurance that assets are safeguarded, transactions are recorded in accordance with our policies and the financial information is reliable.

The financial statements have been prepared in conformity with generally accepted accounting principles applied on a consistent basis, and include amounts based upon our estimates and judgments, as required. The financial statements have been audited by certified public accountants who have expressed their opinion, presented below, with respect to the fairness of the statements. Their examination included a review of the system of internal control and tests of transactions to the extent they considered necessary to render their opinion.

The Audit Committee of the Board of Directors is composed of nonemployee directors. The Audit Committee meets on a regular basis with management, our internal auditors and certified public accountants to review audit plans, results and recommendations, as well as the effectiveness of our system of internal control.

Both our certified public accountants and internal auditors have free access to the Audit Committee.



Robert G. Dettmer
Executive Vice President
and Chief Financial Officer

Report of Certified Public Accountants

Board of Directors and Shareholders
PepsiCo, Inc.

We have examined the accompanying consolidated statement of financial condition of PepsiCo, Inc. and subsidiaries at December 27, 1986 and December 28, 1985, and the related consolidated statements of income, changes in financial condition and shareholders' equity for each of the three years in the period ended December 27, 1986, appearing on pages 32, 33, 34, 36, 38 and 40 through 46. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements mentioned above present fairly the consolidated financial position of PepsiCo, Inc. and subsidiaries at December 27, 1986 and December 28, 1985 and the consolidated results of operations and changes in financial position for each of the three years in the period ended December 27, 1986, in conformity with generally accepted accounting principles applied on a consistent basis during the period.



277 Park Avenue
New York, New York
February 3, 1987

Selected Financial Data

PepsiCo, Inc. and Subsidiaries

(in millions except per share, shareholder and employee amounts, unaudited)

	1986 ^(a)	1985	1984	1983	1982 ^(b)
Summary of Operations					
Net sales	\$ 9,290.8	7,653.4	7,107.6	6,609.5	6,267.8
Cost of sales and operating expenses	8,470.2	6,882.8 ^(c)	6,537.8 ^(c)	6,042.3	5,719.1 ^(d)
Interest expense	263.2	195.4	205.1	175.2	163.5
Interest income	(122.9)	(96.4)	(86.1)	(53.6)	(49.1)
	<u>8,610.5</u>	<u>6,981.8</u>	<u>6,656.8</u>	<u>6,163.9</u>	<u>5,833.5</u>
Income from continuing operations before income taxes	680.3	671.6	450.8	445.6	434.3
Provision for income taxes	222.5	251.5	175.8	167.3	230.8
Income from continuing operations	<u>\$ 457.8</u>	<u>420.1</u>	<u>275.0</u>	<u>278.3</u>	<u>203.5</u>
Income per share from continuing operations	\$ 1.75	1.50 ^(e)	.97 ^(e)	.98	.73 ^(d)
Average shares and equivalents outstanding	# 262.2	280.7	287.5	286.4	284.7
Cash dividends declared	\$ 162.6	161.2	156.2	151.4	147.1
Per share	\$.628	.585	.555	.540	.527
Year-End Position					
Total assets	\$ 8,028.6	5,892.9	4,876.4	4,421.1	4,005.4
Long-term debt (e)	\$ 2,632.6	1,162.7	669.6	799.8	843.9
Shareholders' equity	\$ 2,059.1	1,837.7	1,853.4	1,794.2	1,650.5
Per share	\$ 7.91	6.98	6.58	6.39	5.89
Shares outstanding	# 260.3	263.1	281.7	280.7	280.1
Statistics and Ratios					
Return on average shareholders' equity (f)	% 23.5	22.8	15.1	16.2	12.7
Return on net sales (f)	% 4.9	5.5	3.9	4.2	3.2
Long-term debt (e) to total capital employed (g)	% 43.6	26.5	18.7	23.6	28.3
Total debt to total capital employed	% 47.5	34.4	26.5	31.7	34.6
Employees	# 214,000	150,000	150,000	154,000	133,000
Shareholders of record	# 87,000	72,000	62,000	60,000	48,000

General: The above amounts have been adjusted to reflect certain reclassifications and a three-for-one stock split described in Notes to Consolidated Financial Statements.

(a) Includes the effects of Kentucky Fried Chicken, MEI Corporation and Seven-Up International from their respective dates of acquisition.

(b) PepsiCo adopted the Statement of Financial Accounting Standards (SFAS) No. 52 on foreign currency translation. Prior years were not restated for SFAS 52.

(c) In 1984 a \$156.0 charge was recorded related to the sale of several company-owned foreign bottling operations (\$62.0 after-tax or \$.22 per share). In 1985 a \$26.0 credit was recorded as an adjustment to the 1984 charge (\$15.0 after-tax or \$.05 per share).

(d) Includes a \$79.4 (\$.28 per share) charge, without tax benefit, related to a reduction in net assets of certain foreign bottling operations.

(e) Long-term debt includes capital lease obligations.

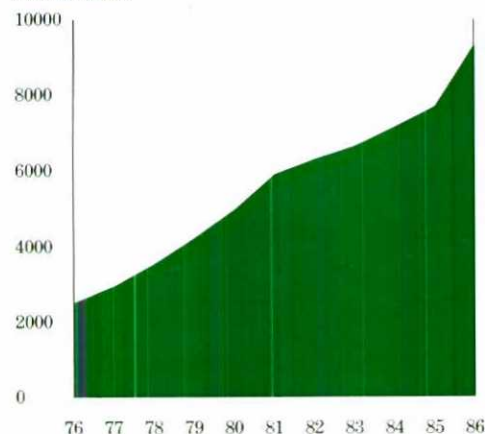
(f) The return on average shareholders' equity and return on net sales were calculated using income from continuing operations.

(g) Total capital employed is total debt, shareholders' equity, deferred income taxes and other liabilities and deferred credits.

1981	1980	1979	1978	1977	1976
<u>5,873.3</u>	<u>4,955.9</u>	<u>4,198.9</u>	<u>3,523.7</u>	<u>2,939.7</u>	<u>2,498.8</u>
5,278.8	4,435.7	3,734.7	3,104.6	2,586.3	2,222.4
147.7	112.7	71.2	50.1	44.9	42.6
<u>(35.8)</u>	<u>(27.1)</u>	<u>(21.9)</u>	<u>(19.3)</u>	<u>(21.7)</u>	<u>(23.1)</u>
<u>5,390.7</u>	<u>4,521.3</u>	<u>3,784.0</u>	<u>3,135.4</u>	<u>2,609.5</u>	<u>2,241.9</u>
482.6	434.6	414.9	388.3	330.2	256.9
213.7	200.3	176.3	179.8	154.7	121.7
<u>268.9</u>	<u>234.3</u>	<u>238.6</u>	<u>208.5</u>	<u>175.5</u>	<u>135.2</u>
.97	.86	.86	.75	.64	.50
279.2	273.5	278.4	278.6	276.1	271.8
129.9	114.9	102.4	88.4	67.0	47.8
.473	.420	.368	.325	.275	.211
3,883.1	3,261.1	2,750.1	2,257.3	2,002.9	1,607.3
804.6	769.5	601.2	459.9	463.1	418.5
1,556.3	1,509.7	1,387.2	1,336.7	1,159.5	1,010.1
5.66	5.51	5.08	4.79	4.21	3.68
274.8	273.8	272.9	279.2	275.4	274.3
17.5	16.2	17.5	16.7	16.2	14.6
4.6	4.7	5.7	5.9	6.0	5.4
27.0	29.6	27.1	23.5	26.7	27.3
40.7	34.9	31.3	26.3	29.2	30.3
120,000	111,000	105,000	95,000	83,000	77,000
49,000	51,000	53,000	55,000	52,000	48,000

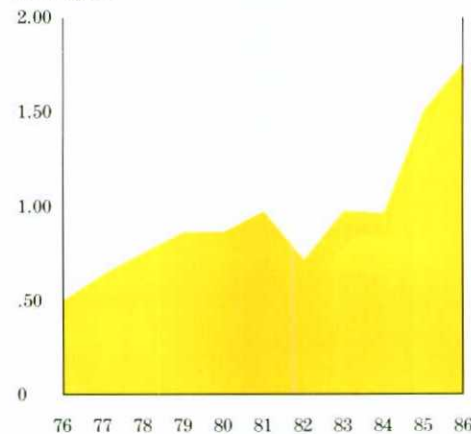
Net Sales

(\$ In Millions)



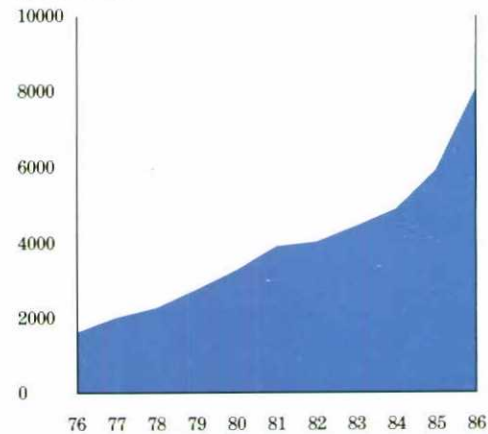
Income Per Share From Continuing Operations

(In Dollars)



Total Assets

(\$ In Millions)



Quarterly Financial Data and Information on Capital Stock

(in millions except per share amounts, stock prices and price/earnings ratio, unaudited)

	First Quarter (12 weeks)		Second Quarter (12 weeks)		Third Quarter (12 weeks)		Fourth Quarter (16 weeks)		Full Year (52 weeks)	
	1986	1985	1986	1985	1986	1985	1986	1985	1986	1985
Net sales	\$1,720.2	1,552.7	2,051.2	1,834.6	2,399.4	1,956.9	3,120.0	2,309.2	9,290.8	7,653.4
Gross profit	\$1,013.1	908.4	1,218.5	1,077.6	1,435.0	1,152.4	1,892.4	1,366.7	5,559.0	4,505.1
Income from continuing operations	\$ 68.7	60.5	120.7	119.3	151.7	135.3	116.7	105.0 ^(a)	457.8	420.1
Income (loss) from discontinued operations	\$ -	2.3	-	137.0 ^(b)	-	-	-	(15.7) ^(c)	-	123.6
Net income	\$ 68.7	62.8	120.7	256.3	151.7	135.3	116.7	89.3	457.8	543.7
Income (loss) per share:										
Continuing operations	\$.26	.21	.47	.42	.58	.48	.44	.39 ^(a)	1.75	1.50
Discontinued operations	\$ -	.01	-	.49	-	-	-	(.06) ^(c)	-	.44
Net income per share	\$.26	.22	.47	.91	.58	.48	.44	.33	1.75	1.94
Cash dividends declared per share ^(d)	\$.148	.140	.160	.149	.160	.148	.160	.148	.628	.585
Market price of Capital Stock ^(d) :										
High	\$ 28½	17⅞	35⅞	20	35⅞	20⅞	29⅞	25⅞	35⅞	25⅞
Low	\$ 22	13½	26⅞	16⅞	27¼	18⅞	24½	19⅞	22	13½
Close	\$ 26⅞	17¼	34	19⅞	28⅞	19⅞	26¼	23¼	26¼	23¼
Price/Earnings Ratio ^(e)	# 17.3	17.1	21.3	14.9	16.7	13.9	15.0	15.8	15.0	15.8

General: The above amounts have been adjusted to reflect certain reclassifications and a three-for-one stock split described in Notes to Consolidated Financial Statements.

(a) Includes a \$14.9 after-tax credit (\$.05 per share) related to an adjustment of the 1984 charge provided for the sale of several company-owned foreign bottling operations.

(b) Includes a \$139.0 after-tax gain (\$.50 per share) from the sale of North American Van Lines, Inc. and a \$9.3 after-tax loss (\$.03 per share) from the sale of Wilson Sporting Goods.

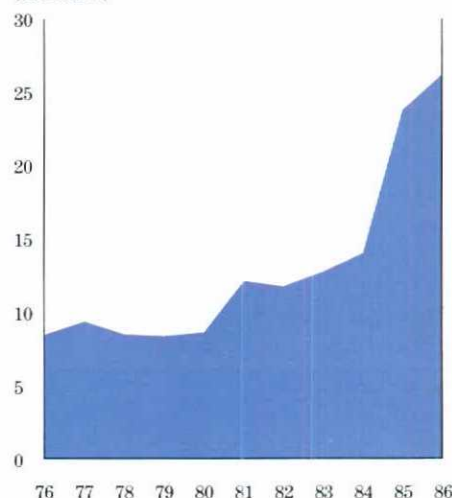
(c) Includes an additional \$8.6 after-tax loss (\$.03 per share) related to the sale of Wilson Sporting Goods and an additional \$7.1 after-tax loss (\$.03 per share) related to the 1984 sale of Lee Way Motor Freight, Inc.

(d) The Capital Stock of PepsiCo is traded in the United States on the New York, Midwest and Pacific stock exchanges. The quarterly dividend was increased seven percent in May 1986 from 15 cents per share to 16 cents per share. In May 1985 the quarterly dividend was increased seven percent from 14 cents per share to 15 cents per share. As of February 20, 1987, the approximate number of holders of record of Capital Stock was 87.1.

(e) Calculated by dividing the closing price of PepsiCo Capital Stock on the last trading day of the quarter by the rolling four quarter income per share from continuing operations for the respective periods.

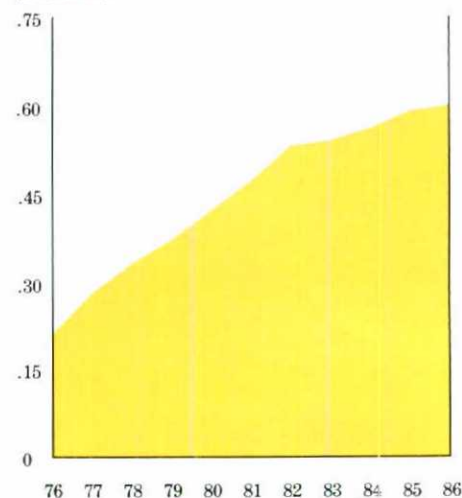
Year-End Stock Price

(In Dollars)



Dividends Per Share

(In Dollars)



Shareholder Information

Capital Stock

Shares of PepsiCo Capital Stock are traded on the New York, Midwest, Pacific, Geneva, Zurich, Amsterdam and Tokyo exchanges. The symbol is PEP, and in most newspaper listings PepsiCo is identified as *PepsiC*.

Stock Performance and Dividend Policy

PepsiCo was formed through the 1965 merger of Pepsi-Cola Company and Frito-Lay, Inc. A \$1,000 investment in our stock made in 1965 was worth approximately \$12,000 on December 27, 1986, assuming dividends were reinvested.

Cash dividends are declared quarterly. On January 1, 1987 PepsiCo's quarterly dividend was \$.16 per share. We've paid quarterly cash dividends since PepsiCo was formed, and dividends have increased for 15 consecutive years.

Dividend Reinvestment Plan

Shareholders may increase their investment in our stock by enrolling in PepsiCo's Dividend Reinvestment Plan. We pay all fees associated with the plan. A brochure explaining this convenient plan is available from our transfer agent:

Manufacturers Hanover Trust Company
450 West 33rd Street
New York, New York 10001

Financial Information

Security analysts and representatives of financial institutions are invited to contact:

Margaret D. Moore
Vice President, Investor Relations
Telephone: (914) 253-3035

Shareholder Inquiries

Questions concerning your dividend reinvestment account, dividend payments or address changes should be addressed to:

Manufacturers Hanover Trust Company
Security Holder Relations
P.O. Box 24935, Church Street Station
New York, New York 10249
Telephone: (212) 613-7147

Please mention PepsiCo, your name as printed on your stock certificate, and include your address and telephone number in all correspondence.

Shareholders' Meeting

The Annual Meeting of Shareholders will be held at PepsiCo World Headquarters on Anderson Hill Road, Purchase, New York, at 10 a.m. (EDT), Wednesday, May 6, 1987. Proxies for the meeting will be solicited by a separate Proxy Solicitor. This Annual Report is not part of the proxy solicitation.

If you need additional assistance or information, or would like to receive free of charge copies of PepsiCo's Form 10-K and 10-Q Reports filed with the Securities and Exchange Commission, contact:

Manager of Shareholder Relations
PepsiCo, Inc.
Purchase, New York 10577
Telephone: (914) 253-3055

Principal Divisions

PepsiCo Worldwide Beverages
Pepsi-Cola Company
Somers, New York 10589
Roger A. Enrico, President

Pepsi USA
Ronald W. Tidmore, President

Pepsi-Cola Bottling Group
Craig Weatherup, President

Pepsi USA Food Service
John M. Cranor, III, President

Pepsi-Cola International
Robert H. Beeby, President

PepsiCo Wines and Spirits International
Purchase, New York 10577
Norman Heller, President

PepsiCo Worldwide Foods
Frito-Lay, Inc.
Plano, Texas 75024
Michael H. Jordan, President

PepsiCo Foods International
400 Frito-Lay Tower
Dallas, Texas 75235
John S. Pingel, Jr., President

Kentucky Fried Chicken Corporation
1441 Gardiner Lane
Louisville, Kentucky 40232
Richard P. Mayer, Chairman

Pizza Hut, Inc.
9111 East Douglas
Wichita, Kansas 67207
Steven S Reinemund, President

Taco Bell Corp.
17901 Von Karman
Irvine, California 92714
John E. Martin, President

PepsiCo Food Service International
Purchase, New York 10577
Graham G. Butler, President

La Petite Boulangerie, Inc.
591 Redwood Highway
Mill Valley, California 94941
Arthur G. Gunther, President

PepsiCo Directors and Officers

Directors

D. Wayne Calloway
Chairman of the Board
and Chief Executive Officer
PepsiCo, Inc.
Committees: Executive

Frank T. Cary
Chairman of the Executive
Committee, International Business
Machines Corporation
Committees: Audit,
Compensation, Executive

William T. Coleman, Jr.
Partner, O'Melveny & Myers
Committees: Audit, Compensation

Roger A. Enrico
President
PepsiCo Worldwide Beverages

Clifton C. Garvin, Jr.
Retired Chairman of the Board and
Chief Executive Officer
Exxon Corporation
Committees: Audit (chairman),
Compensation, Executive

Michael H. Jordan
President
PepsiCo Worldwide Foods
Committees: Executive

Donald M. Kendall
Chairman of the Executive Committee
PepsiCo, Inc.

John J. Murphy
Chairman, Chief Executive
Officer and President
Dresser Industries
Committees: Audit, Compensation

Andrall E. Pearson
Professor, Harvard Business School

Sharon Percy Rockefeller
Member, Board of Directors
Corporation for Public Broadcasting
Committees: Audit, Compensation

Robert H. Stewart, III
Chairman of the Board and
Chief Executive Officer
InterFirst Corporation
Committees: Audit,
Compensation (chairman), Executive

Robert S. Strauss
Partner, Akin, Gump, Strauss,
Hauer & Feld
Committees: Audit, Compensation

Dr. Arnold R. Weber
President, Northwestern University
Committees: Audit, Compensation

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Chief Executive Officer

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Chairman of the Executive Committee

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Controller

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Abdul Rashid
Asset Management
and Corporate Services

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Compensation and Benefits

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Assistant Officers

Janet M. Lavine, Assistant Treasurer

Claudia E. Morf, Assistant Treasurer

Gary M. Stone, Assistant Controller

Executive Offices

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Design: Eisenman & Enock, Inc.
Printing: National Bickford Foremost
Photography: Stephen Wilkes, Ben Rosenthal

